

1989

Unsecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral

David Gray Carlson

Benjamin N. Cardozo School of Law, dcarlson@yu.edu

Follow this and additional works at: <https://larc.cardozo.yu.edu/faculty-articles>



Part of the [Law Commons](#)

Recommended Citation

David G. Carlson, *Unsecured Claims Under Bankruptcy Code Sections 506(a) and 1111(b): Second Looks at Judicial Valuations of Collateral*, 6 Bankruptcy Developments Journal 253 (1989).

Available at: <https://larc.cardozo.yu.edu/faculty-articles/253>

This Article is brought to you for free and open access by the Faculty at LARC @ Cardozo Law. It has been accepted for inclusion in Articles by an authorized administrator of LARC @ Cardozo Law. For more information, please contact christine.george@yu.edu, carissa.vogel@yu.edu.

Articles

UNDERSECURED CLAIMS UNDER BANKRUPTCY CODE SECTIONS 506(a) AND 1111(b): SECOND LOOKS AT JUDICIAL VALUATIONS OF COLLATERAL

by
David Gray Carlson*

TABLE OF CONTENTS

INTRODUCTION	254
I. 506(a) VALUATIONS	258
A. <i>Sales Free and Clear of Liens</i>	260
B. <i>Avoidance Under Section 506(d)</i>	263
C. <i>The Creditor's Right to Bid In</i>	272
II. THE SECTION 1111(b) ELECTION	279
A. <i>Non-recourse Lenders Under Section 1111(b)</i>	279
B. <i>Recourse Lenders Under Section 1111(b)</i>	282
C. <i>Eligibility to Elect Under Section 1111(b)</i>	285
D. <i>What the Election Does</i>	288
1. <i>"To the Extent Such Claim is Allowed"</i>	289
2. <i>The Orthodox Interpretation of the Election</i> ...	291
a. <i>Long Payouts</i>	292
b. <i>Default</i>	294
E. <i>A Counter-Reading of Section 1111(b)</i>	300
III. CONCLUSION	304

* Professor of Law, Benjamin N. Cardozo School of Law, Yeshiva University. Thanks go to Karen Gross, Frank Kennedy, Lynn LoPucki, Paul M. Shupack, and Barry Zaretsky for reading an earlier version of this Article. This article will eventually become a Chapter in G. GILMORE & D. CARLSON, *SECURITY INTERESTS IN PERSONAL PROPERTY* (2d ed.) (forthcoming).

INTRODUCTION

Section 506(a)¹ provides the rule for undersecured creditors. They must be given two claims: one fully secured and one fully unsecured. This division requires the court to value the collateral in order to determine the amount of each of the two claims.² Simple this may seem, but beneath the easy dualism of the Bankruptcy Code³ are turbulent contradictions that have yet to be fully digested in bankruptcy theory.

The basic issue to be addressed in this article is whether bankruptcy valuations are final, or whether bankruptcy courts may change them as the circumstances require. If a Section 506(a) valuation is final and irreversible (as some doctrines take it to be), then the trustee has a powerful incentive to denigrate the value of the collateral at a Section 506(a) valuation hearing and turn around and sell the same collateral at a high price, so that the profit that would have gone to the secured party may be kept by the trustee for the general creditors. Such a practice constitutes the creation of debtor equity where none existed before, and it amounts to an arbitrage between the bankruptcy court's low valuation and the higher price a buyer pays at a later sale.

Against this abusive potential in the Code stands several protective devices. These safeguards have the ironic quality of implying that the danger identified above is a reality. That is, safeguards against bankruptcy valuations imply that valuations are final. One such safeguard

¹ 11 U.S.C. § 506(a) (1982 & Supp. III 1985)

² Because collateral value changes over time, the point at which the valuation is undertaken is important. For a very good essay on this question, see Note, *Bankruptcy Code § 506(a) and Undersecured Creditors: What Date for Valuation?*, 34 UCLA L. REV. 1953 (1987) [hereinafter UCLA Note]. The author reports that when the value of collateral appreciates after the bankruptcy petition is filed, courts have unanimously chosen the date of the petition as relevant. *Id.* at 1956 (citing *In re Rappaport*, 19 Bankr. 971 (Bankr. E.D. Pa. 1982); *In re Pitre*, 11 Bankr. 777 (Bankr. N.D. Ill. 1981); *In re Tanner*, 14 Bankr. 933 (Bankr. W.D. Pa. 1981)). But when the value of collateral has declined, the author has identified three different positions that courts actually take: (1) the petition date, e.g., *In re Brager*, 39 Bankr. 441, 443 (Bankr. E.D. Pa. 1984), *aff'd sub nom.* *Brager v. Blum*, 49 Bankr. 626 (E.D. Pa. 1985); (2) the date of the valuation hearing, e.g., *In re Stafford*, 24 Bankr. 870, 872 (Bankr. D. Kan. 1982); and (3) the date a Chapter 11 plan is confirmed. *In re Cook*, 38 Bankr. 870, 872 (Bankr. D. Utah 1984). See UCLA Note, *supra*, at 1968-71.

³ Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (codified at 11 U.S.C. §§ 101-1330), as amended by Bankruptcy Amendments and Federal Judgeship Act of 1984, Pub. L. No. 98-353, 98 Stat. 333 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); Bankruptcy Judges, United States Trustees and Family Farmer Bankruptcy Act of 1986, Pub. L. No. 99-554, 100 Stat. 3114 (codified as amended in various sections of 11 U.S.C. and 28 U.S.C.); and, Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334, 102 Stat. 610 (codified as amended in various sections of 11 U.S.C.) [The 1978 Act, as amended to date, will hereinafter be referred to as the "Code"].

holds that a secured party who objects to a low judicial valuation may bid in her claim at the auction.⁴ That is, instead of competing in the auction with cash, like everybody else, the undersecured party may bid in her claim as an offset.⁵ Later, the secured party can proceed to resell the collateral at a profit for its "true" value. If the bid-in sale provision worked smoothly, the undersecured party would be protected against low valuations by the bankruptcy court. Unfortunately, there are numerous flaws and contradictions in the governing provision. These will be set forth below, and a sensible reading of the statute will be suggested to avoid these problems.

A second safeguard against incorrect valuations of collateral is the infamous Section 1111(b)⁶ election, a power of undersecured creditors that exists only in Chapter 11 proceedings. Section 1111(b) provides that if an undersecured party makes such an election, "then notwithstanding Section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed."⁷ This opaque language is usually read to mean that if an undersecured creditor qualifies to make the election, she may insist that the Chapter 11 plan pay the undersecured creditor 100 percent of the face amount of the claim. This is the orthodox reading of Section 1111(b), and one this article will argue against.

A numerical example will explain the consequences of the orthodox reading. Suppose *A* has lent \$1,000,000 to the debtor. The collateral is worth \$100,000. There are no liens other than *A*'s on the collateral. Therefore, *A*'s secured claim has a Section 506(a) ceiling of \$100,000. That is, *A* is deemed to have a totally secured claim of \$100,000 and an unsecured claim of \$900,000. If the undersecured creditor makes the Section 1111(b) election, the undersecured creditor must receive \$1,000,000 under the Chapter 11 plan, thereby gaining a preference of \$900,000 over other general creditors. This remarkable effect is more than tempered by the suggestion that the Chapter 11 plan can provide that the \$1,000,000 in payments be paid over time, and that the present value of the payments might be as low as the collateral value—\$100,000.⁸ For example, if we

⁴ 11 U.S.C. § 363(k) (1982 & Supp. IV 1986).

⁵ For example, if *A* has a secured claim of \$10,000 against collateral, and if *A* is the high bidder at an auction at which *A* bids \$10,000, *A* need not pay the \$10,000 purchase price in cash. Instead, *A* may satisfy her obligation to pay the purchase price by offsetting, or "bidding in," her \$10,000 claim against the debtor.

⁶ 11 U.S.C. § 1111(b)(2) (1982).

⁷ *Id.* (emphasis added).

⁸ The suggestion appears in 11 U.S.C. § 1129(a)(7)(B) (1988), which provides:

(7) With respect to each impaired class of claims . . .

assume a single balloon payment of principle at the end of a fixed period and continuously compounding interest at a 10% rate, the debtor-in-possession could defer paying \$1,000,000 for twenty-three years. Such a delay would reduce the \$1,000,000 total claim to a present value of \$100,000.* Thus, what the Section 1111(b) election giveth (a \$900,000 preference), arithmetical manipulation (an extremely long payout) taketh away.

It will be my purpose to argue against such a sterile reading. Putting my theory of the Section 1111(b) election together with my views on bankruptcy valuations, I will argue that until a Chapter 11 plan is adopted, a bankruptcy court is free to adjust the Section 506(a) valuation to correct any "mistakes." Only the Chapter 11 plan itself may set a firm limitation on collateral value. Meanwhile, the purpose of the Section 1111(b) election is to repeal the Section 506(a) ceiling on collateral as it exists in a Chapter 11 plan. An electing secured party would then be entitled to any appreciation in value that occurs in the collateral, even after the plan is confirmed. In the above example, the undersecured creditor will initially be allocated \$100,000. Before the Chapter 11 plan is confirmed, this amount may be adjusted, consistent with the secured party's right to adequate protection. The Chapter 11 plan may freeze the secured party at \$100,000, but the secured party, if eligible, may elect to repeal the strict \$100,000 ceiling on the secured party's entitlements. The election entitles the secured party to post-confirmation adjustments and re-

(B) if § 1111(b)(2) . . . applies . . . each holder of a claim . . . will receive or retain . . . property of a value, *as of the effective date of the plan*, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims. (emphasis added).

* If A = today's desired value of \$100,000, V = \$1,000,000 in desired future payout, r = 10 % interest compounded continuously, e = 2.71828, "the year-end value to which a principal of \$1 will grow if interest at the rate of 100 percent per annum is compounded continuously," CHIANG, *FUNDAMENTAL METHODS OF MATHEMATICAL ECONOMICS*, at 289 (2d ed. 1974), and t = years required to match present value and eventual payout (the variable we seek here), then the relation between A and V can be expressed as

$$A = Ve^{-rt}$$

Substituting our numbers:

$$\$1,000,000 = \frac{\$100,000}{e^{-.1t}}$$

or

$$e^{-.1t} = 10$$

$$.1t = \ln 10$$

$$.1t = 2.3025851$$

$$t = 23 \text{ years, } 9 \text{ days, } 3 \text{ hours}$$

examinations notwithstanding the Section 506(a) valuation. Under this reading of the Code, if the collateral value happens to increase, the increase goes to the secured party.

The article proceeds as follows. Part One of this article discusses the rights of an undersecured creditor under Section 506(a), which requires a bankruptcy court to divide the undersecured creditor's claim into its secured and unsecured parts. In particular, I will examine whether a court might change its mind after an initial Section 506(a) valuation and award a secured party more (or less) at a later time. This ends up being a very unsettled question. This issue will also entangle us in other sections of the Code that relate to undersecured parties—Section 506(d) (relating to discharge of the unsecured portion of an undersecured claim) and Section 363(k) (which pertains to the right of undersecured parties to bid in their claims at trustee-run auctions). Each of these sections is so confusing that painful digressions as to their meaning will be required.

In Part Two, I discuss the Section 1111(b) election. As a preliminary matter, I will present an extraordinary effect that Chapter 11 has on non-recourse lenders.¹⁰ Under Section 1111(b)(1)(A), many undersecured non-

¹⁰ By "non-recourse," I mean that the secured party has the right to foreclose on the collateral but does *not* have the right to sue the debtor personally for the underlying debt. The Second Circuit has described non-recourse lending as follows:

A non-recourse clause normally is intended to reduce the risks to the party granting the security interest if the secured party is later forced to foreclose on the security. By precluding the secured party from getting a deficiency judgment against him, the debtor contains the risk of loss to the security alone. . . .

Vintero Corp. v. Corporacion Venezolana de Fomento, 735 F.2d 740, 742 (2d Cir.), *cert. denied*, 465 U.S. 1087 (1984) (citation omitted).

The definitional machinery for undersecured creditors in the Code is cumbersome. "Claim" is defined as "right to payment . . . secured or unsecured." 11 U.S.C. § 101(4)(A) (1988). Non-recourse lenders more or less have a claim under this definition. They have the right to sell the collateral to generate cash proceeds and then the right to the cash proceeds by which the non-recourse lender is paid. This seems close enough to a "right to payment," even though, in fact, the debtor herself has no correlative duty to pay. If non-recourse lenders have "claims," then it follows that they are "creditors." A "creditor" is

(A) an entity that has a claim against the debtor that arose at the time or before the order for relief concerning the debtor; [or]

(B) an entity that has a claim against the estate of a kind specified in § 348(d), 502(f), 502(g), 502(h), or 502(i). . . .

11 U.S.C. § 101(9). Non-recourse lenders have a claim against property of the estate, but these claims are *not* described in 11 U.S.C. § 348(d) (1982 & Supp. IV 1986), or 11 U.S.C. § 502(f)(i) (1982 & Supp. IV 1986). Therefore, non-recourse lenders are not creditors by virtue of § 101(9)(B) and can only be so by virtue of § 101(9)(A). Although they would seem *not* to be creditors under § 101(9)(A) either, 11 U.S.C. § 102(2) (1982 & Supp. IV 1986) happily provides that a "'claim against the debtor' includes [a] claim against property of the debtor." Therefore, it follows that non-recourse lenders are creditors under § 101(9)(A).

recourse lenders are awarded recourse—an unsecured claim against the debtor-in-possession—that would not have existed under state law or even in Chapter 7 liquidation. This entitlement, however, is denied any undersecured creditor who “elects” under Section 1111(b)(2). Thereafter, I will present the orthodox interpretation of the Section 1111(b) election in order to show that this reading does not yield optimal results as applied in real cases. Instead, I will present an alternative reading of the election together with a strong doctrinal demonstration of why the alternative reading is superior to the orthodox reading.

I will conclude with some thoughts on some hidden property notions that all of the above bankruptcy provisions imply. Specifically, the property issue is: who owns the benefit of increasing value of the collateral in light of the fact that a competent valuation already accounts for the odds that the increase in value will or will not materialize?

I. 506(a) VALUATIONS

Secured and unsecured creditors each receive radically different treatment under the Code. Secured creditors are entitled to full value of their claims.¹¹ At least to the extent of their equity cushion, secured parties are

Nothing in the Code explains the extent to which a non-recourse lender has a claim. Is it to the amount of the advances and incidentals made by the non-recourse lender to the debtor, or is there a ceiling set by collateral value? Obviously, the whole idea of no recourse suggests that collateral value constitutes a ceiling. The fact that § 1111(b)(1)(A) changes non-electing non-recourse lenders into recourse lenders suggests that the recourse claim under § 502 is limited by the value of the collateral.

One author reaches this conclusion by taking § 502(b)(1) (bankruptcy court required to disallow claim that “is unenforceable against the debtor and property of the debtor. . .”) and adding a § 506(a) valuation that splits an undersecured claim into its secured and unsecured parts. The idea seems to be that the *entire* non-recourse claim is initially allowed, with no limits, but that the division in § 506(a) disallows a portion of the non-recourse claim, because the deficit is not enforceable against the debtor or his property. See Stein, *Section 1111(b): Providing Undersecured Creditors with Post-confirmation Appreciation in the Value of Collateral*, 56 AM. BANKR. L.J. 195, 204-05 (1982). Such a view does not really help us read § 1111(b)(2), which requires us to know to what extent the secured claim is allowed, *notwithstanding* § 506(a). This idea also contradicts the *automatic nature* of § 506(d), an avoidance provision that is discussed *infra* in text accompanying notes 40-42.

A bill passed by the Senate would have made clearer that once the § 506(a) hearing occurred, the non-recourse claim became limited to the value of the collateral, with the unsecured portion being disallowed. Unfortunately, the bill died in the House of Representatives. S. 863, 97th Cong., 1st Sess. § 33(a) (1981). See Stein, *supra*, at 205 n.39. As a result, definitional exegesis presented in this footnote has been long and tortured.

These observations may prove nothing more than the fact that even skilled draftspersons face enormous difficulties in crafting adequate definitions. Let us therefore ignore the definitions and simply assume that the non-recourse lender is a *creditor* whose *claim* is limited to the maximum amount of collateral value.

¹¹ 11 U.S.C. § 725 (1982 & Supp. III 1985); 11 U.S.C. § 1129(a)(7) (1988).

entitled to post-petition interest.¹³ They need not be paid immediately and their repossessory powers are stayed.¹³ Nevertheless, they are entitled to adequate protection of their interests to assure that, over time, the collateral does not decrease in value.¹⁴ This is, at least, the theory, and perhaps the practice, of the Code.

Meanwhile, unsecured creditors receive no post-bankruptcy interest¹⁵ (unless, by some miracle, there is a surplus after all the principal amounts of creditor claims are paid).¹⁶ Furthermore, as time goes by, the bankrupt estate can be (and usually is) eaten away by expensive administrative costs, from which secured creditors are largely exempt.¹⁷ For these reasons, secured creditors are treated much better in bankruptcy than are unsecured creditors.

So strong is the bicameral instinct to divide all creditors into either secured or unsecured categories that the Code forces *undersecured* creditors to divide their claims into two parts: one fully secured and one fully unsecured.¹⁸ The fully secured part is entitled to adequate protection of its value and the fully unsecured part is entitled to none. How seriously do we take this split of the undersecured creditor's claim into an *in personam* claim and a non-recourse *in rem* claim against the collateral? Can it be corrected later when it appears the valuation was too conservative, or does the Section 506(a) valuation create a ceiling that can be overcome only by one of the express protections that the Code provides undersecured creditors?

This ends up being a very important question in assessing how numerous bankruptcy provisions interact with each other. Surprisingly, there is remarkably little authority on either point. Here is some legislative history:

¹³ 11 U.S.C. § 506(b) (1982 & Supp. III 1985). There are many hidden controversies with regard to this statement which are covered in Carlson, *Postpetition Interest Under The Bankruptcy Code*, 43 U. MIAMI L. REV. 577, 636-53 (1989).

¹⁴ 11 U.S.C. § 362(a) (1982 & Supp. IV 1986).

¹⁵ 11 U.S.C. § 363(e) (1982 & Supp. IV 1986).

¹⁶ 11 U.S.C. § 502(b) (1982 & Supp. IV 1986).

¹⁷ 11 U.S.C. § 726(a)(5) (1982 & Supp. IV 1986); 11 U.S.C. § 1129(a)(7) (1988). Even then, creditors are entitled only to the usually mediocre "legal" rate of interest instead of the higher contract rate.

¹⁸ *In re By-Rite Oil Co.*, 87 Bankr. 905, 919-21 (Bankr. E.D. Mich. 1988). If the administrative expense relates to preserving the value of, or to selling, the collateral, the bankruptcy trustee may charge the administrative expense to the collateral. 11 U.S.C. § 506(c) (1982 & Supp. III 1985).

¹⁹ *Hanson v. First Bank of South Dakota*, 828 F.2d 1310 (8th Cir. 1987) (the unsecured portion of undersecured creditors' claims may be classified with unsecured creditors because they are "substantially similar").

While courts will have to determine value on a case-by-case basis, the subsection makes clear that valuation is to be determined in light of the purpose of the valuation and the proposed disposition or use of the subject property. To illustrate, a valuation early in the case in a proceeding under [S]ections 361-363 would not be binding upon the debtor or creditor at the time of confirmation of the plan.¹⁹

In this passage, the authors of the legislative history state flatly that second looks under Section 506(a) must be allowed, but a careful reading of this passage reveals that they did not mean to say that Section 506(a) valuations could not constitute a ceiling on undersecured creditor entitlements to collateral. Rather, they imply that the ceiling has to be part of the Chapter 11 plan. Therefore, it appears that flexibility exists up until such time as a Chapter 11 plan is confirmed. By implication, in Chapter 7 liquidations, Section 506(a) valuations might never constitute ceilings on undersecured creditor entitlements.²⁰

A. Sales Free and Clear of Liens

The sincerity of the Section 506(a) valuation as a fixed ceiling can be tested in interpreting Section 363(f)(3). Under this section, the trustee may sell free and clear of liens, but only if "the price at which such property is to be sold is greater than the aggregate value of all liens on such property."²¹ Suppose *A* (who is senior) and *B* (who is junior) are secured

¹⁹ S. REP. NO. 989, 95th Cong., 2d Sess. 68, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5854 (emphasis added). See *In re Richardson*, 97 Bankr. 161, 162 (W.D.N.Y. 1989) ("A valuation made for one purpose is not *res judicata* as to a later valuation in the same case for a different purpose."); *In re Terrace Gardens Park Partnership*, 96 Bankr. 707, 710 (Bankr. W.D. Tex. 1989) ("But it is sheer arrogance for any bankruptcy court to maintain that it can, in the space of a few hours of hearing testimony, actually *set* values with binding collateral estoppel or *res judicata* effect.").

²⁰

[T]his valuation is to be used only for purposes of determining what constitutes adequate protection for the Bank under section 363 of the Bankruptcy Code. . . . Additionally, a determination of what portion of an allowed claim is secured and what portion is not, is binding only for the purpose for which the determination is made. Thus, determinations for purposes of adequate protection are not binding for the purposes of "cram down" on confirmation in a case under Chapter 11.

In re Datair Systems Corp., 42 Bankr. 241, 243-44 (Bankr. N.D. Ill. 1984) (citations omitted); accord *In re Valley Park Group, Inc.*, 96 Bankr. 16, 24 (Bankr. N.D.N.Y. 1989).

²¹ 11 U.S.C. § 363(f)(3) (1982 & Supp. IV 1986) (emphasis added). There are other provisions in § 363(f)(3) that might provide for a sale free and clear of liens. Subsection (1), for example, provides that the trustee may sell, free and clear of any property interest, if "applicable nonbankruptcy law permits [it]." This allows a bankruptcy trustee to sell inventory free and clear of security

creditors who each claim \$350. Each claims a lien on the same piece of collateral. How high must the bid be before the trustee can sell the collateral free and clear of liens? The preferred reading is that the trustee may not sell for anything less than \$700.²² Such a reading of Section 363(f) suggests that when the debtor has equity that would benefit general creditors, the trustee should seize jurisdiction over the sale and run it herself. Common wisdom has it that leaving the secured parties to sell is an inferior result, because secured parties have the incentive to obtain only enough of a bid to cover their own particular claims. Any work thereafter is done for the benefit of the debtor, which secured parties may not be willing to do. Meanwhile, if the value of the collateral is below the face amount of the secured creditor's claim, the trustee should abandon the collateral to the secured parties;²³ the trustee works for the general creditors, and such a low price implies that the general creditors can get no benefit from the trustee's efforts.²⁴

interests (in the ordinary course of business) because state law allows the debtor to do so. U.C.C. § 9-307(1) (1987). Subsection (5) might also provide for a sale free and clear of liens. Subsection (5) provides for a "free and clear" sale whenever "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest." Because security interests secure debt obligations, it does not seem difficult to argue that secured parties can be forced to accept cash in satisfaction of a security interest. One case has limited the use of § 363(f)(5) to cases in which the lien creditors have received 100 cents on the dollar in lieu of foreclosure. *Richardson v. Pitt County (In re Stroud Wholesale, Inc.)*, 47 Bankr. 999 (Bankr. E.D.N.C. 1985).

The strategy about to be suggested to enrich bankrupt estates would work under any provision allowing a sale of collateral free and clear of liens, except for § 363(f)(5) as read by the *Stroud Wholesale* court.

²² *Stroud Wholesale*, 47 Bankr. at 1001-02. See also H.R. REP. NO. 595, 95th Cong., 1st Sess. 345, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6301 ("The trustee may sell free and clear if . . . the sale price of the property is greater than the amount secured by the lien.").

²³ *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555, 584 (1935) ("By the settled practice, a sale free of liens will not be ordered by the bankruptcy court if it appears that the amount of the encumbrance exceeds the value of the property.") (footnote omitted); *In re Terrace Gardens Park Partnership*, 96 Bankr. 707, 712 (Bankr. W.D. Tex. 1989); *Noland v. Williamson (In re Williamson)*, 94 Bankr. 958, 962-63 (Bankr. S.D. Ohio 1988).

²⁴ To this I would add one exception. If a secured party has liens on two pieces of collateral, but no one piece of collateral is enough to satisfy the claim in full, it should be possible for the trustee to sell the collateral even though it is not necessary for a reorganization, or if there is no debtor equity. For example, suppose a secured party has a total claim of \$750 and two pieces of collateral worth \$400 apiece. Taken together, the debtor has \$50 of equity. The trustee should be able to sell the collateral serially to reach the equity. See 2 COLLIER ON BANKRUPTCY ¶ 363.07 (15th ed. 1989).

Unfortunately, § 363(f)(3) is not flexible enough to provide for this and the preferred rule for single pieces of collateral—that the trustee should sell only if there is debtor equity or need with regard to a reorganization. If a sale is not permitted, then the trustee will have to seek a valuation from the bankruptcy court, followed by an abandonment of one of the items of collateral. On the other hand, perhaps the collateral could be abandoned, the state law foreclosure sale held, and a *post hoc* deduction made in the secured party's remaining bankruptcy claim. But see *In re Caraway*, 95 Bankr.

Unfortunately, some courts have viciously insisted on reading the words of the statute literally. *In re Beker Industries, Corp.*²⁵ interprets Section 363(f)(3) as follows: If *A* and *B* each have claims with a face amount of \$350, but the value of the collateral is \$500, then the value of the two liens together must also be only \$500. That is, the value of the two liens can never exceed the value of the collateral. Therefore, the trustee can hold a sale free and clear of liens²⁶ if some buyer bids more than \$500.²⁷

This interpretation presupposes the view that undersecured creditors are frozen at their original Section 506(a) valuations. If undersecured creditors could simply take cash proceeds up to the face amount of their secured claims, regardless of the Section 506(a) ceiling set by a bankruptcy court, then the trustee could never benefit from the *Beker* interpretation of Section 363(f)(3). Unless secured creditors are frozen at the Section 506(a) valuations, a trustee would never have an incentive to administer a sale that did not attract a bid over \$700.²⁸

Suppose, in accordance with *Beker*, that Section 506(a) does constitute a strict ceiling of entitlements. Then, as one commentator has pointed out,²⁹ the trustee might have an even more sinister incentive with regard to a Section 363(f)(3) sale. By badmouthing the quality of the collateral in a Section 506(a) valuation, the trustee could have a bankruptcy court split the junior creditor's \$350 claim into two parts. For example, assume the trustee persuades a bankruptcy court that the collateral can be sold for no more than \$450, so that *A* is secured for the full \$350 and *B* (the junior creditor) is secured for \$100 and unsecured for \$250. Such a representa-

466 (Bankr. W.D. Ky. 1988) (disapproving of such a *post hoc* deduction and insisting on a present valuation of the collateral before abandonment).

Another exception might be the genuine consent of the secured parties. *In re MMS Builders, Inc.*, 101 Bankr. 426 (D.N.J. 1989). Still, the general creditors could complain if they are paying a trustee to work for a secured party. In *MMS Builders*, however, the trustee was totally compensated by the secured party. *Id.* at 431-32.

²⁵ 63 Bankr. 474 (Bankr. S.D.N.Y. 1986).

²⁶ In a later opinion, the *Beker* court denied permission for a § 363(f)(3) sale because the court felt that the price the trustee had obtained was inadequate and that the collateral would soon appreciate in value. *In re Beker Industries, Corp.*, 64 Bankr. 900, 910-12 (Bankr. S.D.N.Y. 1986), *rev'd on other grounds*, 89 Bankr. 336 (S.D.N.Y. 1988).

²⁷ *In re Terrace Gardens Park Partnership*, 96 Bankr. 707, 712-13 (Bankr. W.D. Tex. 1989); *In re Rouse*, 54 Bankr. 31 (Bankr. W.D. Mo. 1985).

²⁸ See Carlson, *Successor Liability in Bankruptcy: Some Unifying Themes of Intertemporal Creditor Priorities Created by Running Covenants, Products Liability, and Toxic Waste Cleanup*, 50 LAW & CONTEMP. PROBS. 119, 141-42 n.102 (Spring 1987).

²⁹ Note, *Selling Out Undersecured Creditors: "Value" Under § 363(f) of the Bankruptcy Code*, 8 CARDOZO L. REV. 1251, 1254 (1987) [hereinafter Cardozo Note].

tion might be plausible. Valuations are merely predictions of the price a future auction will bring.³⁰ Unless the collateral is highly fungible and stable in price, valuations are inherently uncertain, and, of course, the trustee has the advocate's duty to maximize the position of her unsecured clients. In any case, after badmouthing the collateral to the judge, the trustee might then turn around and so praise the quality of the collateral at an auction that a buyer is willing to bid \$500. This \$500 would go first to A (for \$350), then to B (for \$100, the secured part of her claim), then to the trustee for \$50. This last \$50 properly should have gone to the junior secured creditor.³¹ Through the *Beker* court's reading of Section 363(f)(3), the trustee has an incentive to create debtor equity by disparaging the "true" value of collateral to the bankruptcy judge.³² In fact, the *Beker* reading of Section 363(f)(3) is interesting to trustees only if such a scheme is undertaken; otherwise, the trustee simply sells on behalf of secured creditors and obtains no benefit for the unsecured creditors, out of whose take comes the trustee's commission.

B. Avoidance Under Section 506(d)

Section 506(d) directly supports the idea that the trustee can profit

³⁰ *Id.* at 1261.

³¹ That is, the junior secured party would have received this extra \$50 if there had been no bankruptcy and if the sale had been conducted under the auspices of state law.

³² For a case finding such a scheme unconscionable, see *In re Krueger*, 66 Bankr. 463 (Bankr. S.D. Fla. 1986). According to Judge Britton:

[T]his debtor's scheme is inequitable. In essence, he forces his mortgagee to estimate the current value of his security under § 506, then under § 363(f) the debtor proposes to place the collateral on the market, dictating the time and terms of sale, in the hope that the mortgagee has undervalued the security and can, therefore, be compelled to subordinate its claim to inferior obligations of the debtor. This court cannot permit these statutory provisions to be used by the debtor to take unconscionable advantage of any creditor. I cannot countenance this scheme and I find that this [Chapter 11 plan] has not been proposed in good faith.

Id. at 465. But another case approves of hypocritical claims of value when the creditor is the hypocrite. Creditors who would like to have the automatic stay lifted have an incentive to disparage collateral value. That is, if the creditor has a \$100 claim, the creditor can get the stay lifted if there is no need for the collateral and no reorganization. 11 U.S.C. § 362(d)(2) (1982 & Supp. IV 1986). In such a case, the creditor will want to claim that the collateral is worth less than \$100, but that same creditor has opposite incentives in other contexts. For example, the creditor is entitled to post-bankruptcy interest only if the debtor has equity in the collateral. 11 U.S.C. § 506(b) (1982 & Supp. III 1985). When post-bankruptcy interest is at stake, the creditor has an incentive to claim that the collateral is worth more than \$100. Courts have approved this practice of claiming one value or another as it suits the creditor's interest. See, e.g., *In re Realty Investments, Ltd. V*, 72 Bankr. 143, 146 (Bankr. C.D. Cal. 1987). If secured creditors can enjoy the fruits of this hypocrisy, why not the bankruptcy trustee?

by minimizing collateral value under Section 506(a) and by maximizing it under Section 363(f)(3). Section 506(d) is usually thought to be a provision that benefits debtors, but, as we shall see, the trustee can make creative use of this section as well.

Section 506(d) mysteriously provides: "To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void"³³ This Section allows the trustee to insist that an underwater lien be divided into two parts; the fully secured and fully unsecured parts respectively. The first part becomes "an allowed secured claim." This part survives Section 506(d) and remains a genuine lien. To the extent the lien attempts also to secure the unsecured portion of the bifurcated claim, "such lien is void," according to Section 506(d). As a result, the trustee can use this provision to place a cap on the amount of the underwater liens.³⁴

Let us review the significance of Section 506(d) by means of illustration. Suppose collateral is worth \$500 in its natural unencumbered state. The collateral is encumbered by two security interests, one held by A, who is senior and who has lent \$350, and one held by B, who is junior and who has lent \$350. The trustee asks that the bankruptcy court value the claims under Section 506(a). In the hearing, the court undervalues the collateral at \$450. Accordingly, A's claim is deemed to have a fully secured claim for \$350. B's claim is divided into two. The secured claim is valued at \$100; the unsecured claim is deemed to be \$250. Under Section 506(d), B's lien is limited to \$100; the lien for the \$250 unsecured claim is entirely destroyed.

Because there is no equity in the collateral, the trustee might abandon it to the debtor and any surviving secured creditors.³⁵ Once the trustee has abandoned the collateral, the automatic stay no longer applies to restrain A (whose lien is intact) or B (whose lien has been reduced to \$100). Suppose A moves to foreclose her security interest and, at the auction, a buyer bids \$500. Of this, \$350 goes to extinguish A's claim, \$100 goes to B to extinguish her (secured) claim, and \$50 goes to the debtor.³⁶ Thus,

³³ 11 U.S.C. § 506(d) (1982 & Supp. III 1985).

³⁴ "This Court is of the opinion that § 506(d) is intended merely to facilitate the sale of collateral by the trustee or the debtor-in-possession in order to extinguish the entire lien even though the sale is at a price insufficient to satisfy the lien in full." *In re Maitland*, 61 Bankr. 130, 134 (Bankr. E.D. Va. 1986) (citing *In re Mahaner*, 34 Bankr. 308 (Bankr. W.D.N.Y. 1983)).

³⁵ See 11 U.S.C. § 362(d)(2)(A) (1982 & Supp. IV 1986). Under § 362(d)(2)(B), the trustee need not abandon if the collateral is necessary for a successful rehabilitation. The context here, however, is individual, so that rehabilitation is not a factor.

³⁶ See generally *Kruger v. Beneficial Commercial Corp.* (*In re Kruger*), 77 Bankr. 785 (Bankr.

the debtor has successfully arbitrated between the low valuation in bankruptcy and the "true" value of the collateral outside bankruptcy.³⁷ This is precisely the same scam that I have suggested a trustee might use inside bankruptcy, where the trustee can sell free of liens under Section 363(f)(3).

The existence of this opportunity to arbitrage between low bankruptcy valuations and high real life values was greatly strengthened in the 1984 amendments to the Code. Before 1984, Section 506(d) read as follows:

To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—

- (1) a party in interest has not requested that the court determine and allow or disallow such claim under section 502 of this title; or
- (2) such claim was disallowed only under section 502(e) of this title.³⁸

Notice that the lien was not capped at the Section 506(a) amount unless a "party in interest" affirmatively requested the cap.

Today, Section 506(d) reads as follows:

To the extent that a lien secures a claim against the debtor that is not an allowed secured claim, such lien is void, unless—

- (1) such a claim was disallowed under section 502(b)(5) or 502(e) of this title; or
- (2) such claim is not an allowed secured claim due only to the failure of an entity to file a proof of such claim under section 501 of this title.³⁹

C.D. Cal. 1987) (describing the rules under § 506(d)).

³⁷ United States v. Garnett, 99 Bankr. 757 (W.D. Ky. 1989); Zlogar v. IRS (*In re Zlogar*), 101 Bankr. 1 (Bankr. N.D. Ill. 1989); Tanner v. Financeamerica Consumer Discount Co. (*In re Tanner*), 14 Bankr. 933 (Bankr. W.D. Pa. 1981). The author of an excellent student note usefully reminds us that arbitrating off a bad initial valuation is not the only reason collateral values might go up after a § 506(a) valuation. It may also be the case that, after bankruptcy, the property might appreciate unexpectedly or the debtor might invest in the collateral, or pay down the senior lien. *In re Shrum*, 98 Bankr. 995, 1003-04 (Bankr. W.D. Okla. 1989) (en banc) (Teselle, J., concurring). In these latter two eventualities, the debtor's investment would adhere to the benefit of the undersecured creditor unless § 506(d) voids the unsecured portion of the undersecured creditor's claim. See Note, *The Debtor's Right to Restrict Lienholder Recovery to the Value of the Encumbered Property Under § 506 of the Bankruptcy Code*, 11 J. CORP. LAW 433, 445-48 (1986) [hereinafter Iowa Note]. Generally, in any of these cases, the author of the note favors the debtor over the undersecured party on "fresh start" policy grounds. Iowa Note, *supra*, at 445-48.

³⁸ 11 U.S.C. § 506(d) (1982) (emphasis added). Section 502(e) disallows any subrogation claims by a surety who has not yet paid off the assured creditor. 11 U.S.C. § 502(c) (1982 & Supp. IV 1986). This is a provision that is not relevant to the present analysis.

³⁹ 11 U.S.C. § 506(d) (1982 & Supp. III 1985).

In this revision, no longer does a party have to move for avoidance. Avoidance is automatic, so long as a claim has been filed by (or on behalf of)⁴⁰ a secured creditor.⁴¹ This amendment, by rendering avoidance automatic so long as some claim is filed, seems to strengthen the idea that Section 506(d) implies that undersecured creditors are subject to a strict Section 506(a) limit.⁴²

The ability of a debtor to arbitrage between low bankruptcy court valuations and real market prices has been confirmed by two court of appeals decisions. *In re Folendore*⁴³ is a straightforward endorsement of the debtor's ability to put a ceiling on the amount of the lien. A more complicated endorsement also appears in *Lindsey v. Federal Land Bank (In re Lindsey)*,⁴⁴ where the debtor owned real estate overencumbered by two liens held by A and B. B, the junior creditor, was undersecured. The debtor obtained a Section 506(a) valuation, splitting B's claim into its secured and unsecured parts. The debtor obtained a discharge from the unsecured claim. The debtor also sought a reformation of the mortgage obligations to A and B, so that the debtor could avoid default by making new payments on the suddenly non-recourse secured claims that A and B held against the property of the debtor. The bankruptcy court refused this request and then ordered the collateral abandoned unless, within thirty days, the debtor redeemed the property by paying A and B the total amount of their non-recourse claims.⁴⁵ The debtor did not redeem. In-

⁴⁰ According to § 501, the trustee or the debtor may file a claim if the secured creditor does not. This gives debtors a powerful tool for wresting from their creditors future unrealized value or just plain valuation mistakes. See 11 U.S.C. § 501 (1982 & Supp. III 1985).

⁴¹ See 11 U.S.C. § 506(d)(2) (1982 & Supp. III 1985).

⁴² One implication of the automaticity of § 506(d) is that it should be possible, even after abandonment or exemption, to ask a bankruptcy court for a valuation of collateral, because after all, the lien is already limited in amount and it is necessary to know what that limit is. This is a feature that is ignored in cases where § 506(d) avoidance is disallowed with regard to collateral abandoned before the debtor requests a § 506(a) valuation. *In re Shrum*, 98 Bankr. 995 (Bankr. W.D. Okla. 1989) (en banc); *In re Maitland*, 61 Bankr. 130, 134 (Bankr. E.D. Va. 1986). For the view that a court has discretion not to value collateral under § 506(a) and hence avoid a lien under § 506(d), see Note, *Can A Debtor Void A Real Property Lien That Exceeds The Value Of The Collateral?: An Interpretation Of Section 506(d) Of The Bankruptcy Code*, 45 WASH. & LEE L. REV. 1393, 1413-14 (1988). If § 506(d) avoidance is now automatic, however, there would seem to be no basis for such a view.

⁴³ 862 F.2d 1537, 1539 (11th Cir. 1989) (in dicta, utilizing 11 U.S.C. § 506(d)).

⁴⁴ 823 F.2d 189 (7th Cir. 1987).

⁴⁵ If Article 9 of the Uniform Commercial Code had applied to this transaction, the debtor could have redeemed only by paying A and B the face amounts of their claims. U.C.C. § 9-506 (1987). Under 11 U.S.C. § 722 (1982), D may redeem certain specified personal property by paying the amount of the secured claim, which is always less than the face amount of the claim in cases where the secured party is under water.

stead, the debtor appealed, but without filing a supersedeas bond. Presumably (although the court does not say so), the foreclosure proceedings by *A* and *B* went forward under state law, or at least were ready to go forward. Exactly what remedy the debtor expected from the Court of Appeals was not made clear, but the debtor seemed to expect that *A* and *B* would be enjoined from foreclosure.⁴⁶

Whatever the debtor expected, he did not get it. Judge Richard Posner thought that Section 506(a) could not be used to reform loan agreements. He also made some preliminary remarks suggesting that Section 506(a) could not be used to manufacture debtor equity through arbitraging between valuation hearing and auction.

It would be absurd to think that Chapter 7 could be used, as [the debtors] would use it, just to reduce the amount due on a mortgage. Then in any period of depressed real estate values, when a farmer's liabilities exceeded his assets, he could get the liabilities reduced simply by declaring bankruptcy. . . . The main purpose served by section 506 is to put the secured creditor who chooses to pursue his rights in bankruptcy in the same position that he would occupy if he had decided to bypass bankruptcy. If such a creditor bypassed bankruptcy and foreclosed his lien, he would obtain the market value of the interest secured by the lien and a deficiency judgment for the rest. Section 506 gives him a secured interest that he can foreclose on equal to the market value of his interest, and makes him an unsecured creditor for the rest, which is all that a judgment creditor is anyway. The statute is not intended to put him in a grossly inferior position to what he would occupy outside bankruptcy, by denying him all rights of foreclosure after the debtor has defaulted and the lien has been written down.⁴⁷

⁴⁶ There is some reason to believe the debtor substantially overestimated the jurisdictional power of the Court of Appeals to help him out. If the property had been abandoned, the bankruptcy court would have no further jurisdiction over the property. See *Elscont, Inc. v. First Wisconsin Fin. Corp. (In re Xonics, Inc.)*, 813 F.2d 127, 131-32 (7th Cir. 1987); *In re Hunter*, 76 Bankr. 117 (Bankr. S.D. Ohio 1987) (trustee could not get property back once the property was finally abandoned). Nor did *A* or *B* consent to jurisdiction, because neither filed a claim against the debtor. *In re Lindsey*, 823 F.2d at 191.

⁴⁷ *In re Lindsey*, 823 F.2d at 191 (emphasis in original). There are numerous minor imprecisions and errors in this passage. First, Posner states that, absent bankruptcy, a creditor "would obtain the market value of the interest secured by the lien. . . ." This is either a truism (*i.e.*, whatever the secured party gets is the market value), or wrong (in that there are numerous types of markets producing numerous values). "Market value" is usually a normative term, suggesting that, if the secured creditor does not obtain it from a buyer, she has behaved inappropriately. Under such a meaning, it is not clear that the secured creditor *will* get such a market value.

Second, whether § 506(a) gives the secured creditor a "market value," as Judge Posner assumes,

If read closely this language does not apply to our arbitrage scheme at all. This anti-debtor language goes to the power of *B* to proceed with the foreclosure and the presumption of the debtor to suppose he can stop it. It has nothing to say about the size of the secured claim *B* has in foreclosing, or about whether the debtor or the trustee can arbitrage between bankruptcy value and true value. On this subject, Posner suddenly turns very pro-debtor and, by implication, pro-trustee.

What the statute does for the debtor . . . is enable him to precipitate the foreclosure proceedings, which he might want to do, if real estate prices were temporarily depressed, in order to minimize the secured claims and thus increase the amount available for the unsecured creditors. This presupposes a case in which the trustee is standing in the debtor's shoes and representing the unsecured creditors, rather than a case such as this where the debtor is simply trying to shield as much of his property as possible from the only creditors who are pursuing him.⁴⁸

In this passage, Judge Posner openly espouses a view that the trustee can create debtor equity where none would have existed under state law, through the use of Section 506(a).⁴⁹ This opinion, then, does support an

depends entirely on the predictive skill of the judge. Because no market transaction actually occurs in a § 506(a) hearing, the judge is merely hypothesizing what price a future transaction might bring.

Third, Posner is imprecise in suggesting that judgment creditors are unsecured creditors. Often a judgment portends a lien in and of itself, in which case the judgment creditor is a secured creditor under state law. *E.g.*, N.Y. CIV. PRAC. L. & R. § 5203(a) (McKinney 1978) (creating a judgment lien on real estate).

⁴⁸ *In re Lindsey*, 823 F.2d at 191. This passage suffers from a slight ambiguity. Posner suggests that a debtor can precipitate a foreclosure proceeding. Only a secured creditor could do this. What Posner meant to say is that a debtor could probably provoke a creditor into exercising her foreclosure rights.

⁴⁹ Judge Posner engages in dubious economics, which is surprising, because, as a law professor, he wrote a famous treatise on Law & Economics.

Posner writes of the pressure he receives for "a liberal interpretation of the bankruptcy laws." *Id.* at 192. He accuses liberals, however, of myopia:

There is a strong argument that liberal interpretations of bankruptcy law do not even help farmers, or any other class of debtors, in the long run - that the fewer the rights that creditors have in bankruptcy the higher interest rates will be, because defaults will be more costly to creditors. And interest is paid by debtors. Analysis would be more complicated if the issue were not debtor versus secured creditors, but trustee, representing the unsecured creditors, versus secured creditors; for then higher interest rates on secured debt might be offset by lower interest rates on unsecured debt, leaving debtors' net burdens unchanged.

But this case pits the debtors themselves against the only creditors in the picture. . . .

Id. Posner wants to say that, from the perspective of the debtor, the economic case against anti-creditor regulation is clear because, in the long run, debtors as a class bear the cost of higher interest and obtain no compensating benefit. That is wrong; bankruptcy *does* produce a correlative benefit —

anti-creditor view in which ceilings under Section 506(a) are firm and unchangeable.⁵⁰

Now if the debtor can use Section 506(d) to arbitrage between low bankruptcy valuations and higher prices later, so can the trustee. Section 506(d) voids part of the undersecured creditor's claim, and the voided lien should be preserved for the debtor's estate. On the strength of this observation, some courts have ruled that the *debtor's* use of Section 506(d) is illegitimate.⁵¹ Preservation of a voided lien for the benefit of a bankrupt

the possibility of discharge and hence immunity of post-bankruptcy income from future debt enforcement. This possibility of post-bankruptcy wealth is a benefit against which the cost of higher interest must be weighed. Therefore, the case requires the complicated comparison between costs and benefits and is just like one involving a bankruptcy trustee, which Posner thinks is clearly "more complicated." *Id.*

Furthermore, Posner relies heavily on the functionalist fallacy: that every law produces an economic reaction in society. There are good economic reasons to suppose that such functionalist assumptions are wrong. Lenders usually lend only when the chance of default is small. Within the range of possibilities in default, the bankruptcy rule Posner imagines is itself a very minor contingency. It costs creditors resources to think about such tiny risks; they may find it more convenient to forget about the risk altogether and to concentrate instead on debtor cash flow, asset base and other factors that will make or break the loan. Carlson, *Is Fraudulent Conveyance Law Efficient?*, 9 CARDOZO L. REV. 643, 667-79 (1987) (taking the view that fraudulent conveyance law has no effect on the price of loans for this reason). Under this view, the price of credit will *not* rise if the bankruptcy court fashions a marginally pro-debtor rule, because the cost of reassessing the risk outweighs the risk itself.

What we have from Judge Posner is a romantic yearning for the *per se* efficient event in the world. Unhappily, *all* human activity produces good and bad, which means that we are doomed to very complicated cost-benefit empirical inquiry whenever we practice welfare economic analysis.

⁵⁰ For lower court opinions upholding the debtor's power to cap an undersecured party's lien, see *Garnett v. Farmers Home Admin.* (*In re Garnett*), 88 Bankr. 123, 126 (Bankr. W.D. Ky. 1988) (referring to the scam as the "plain meaning" of § 506(d)). See also *In re Tanner*, 14 Bankr. 933 (Bankr. W.D. Pa. 1981).

For another case supporting the idea that § 506(a) is a strict limit, see *In re Caraway*, 95 Bankr. 466 (Bankr. W.D. Ky. 1988). In *Caraway*, the debtor proposed to abandon part of his farm. The creditor suggested that the § 506(a) split await the actual foreclosure sale that would soon follow. The court insisted, however, on a valuation, which strongly suggests that, if the foreclosure sale were to produce a different amount, the hypothetical valuation would still hold, and the debtor would be able to keep the difference. In other words, the court must have had in mind a *sub rosa* § 506(d) avoidance of the secured creditor's lien, except that the lien was not preserved for the benefit of the estate; rather the *debtor* would benefit from the ceiling on the secured creditor's entitlement. Cf. *Nolan v. Williamson* (*In re Williamson*), 94 Bankr. 958, 966 & n.10 (Bankr. S.D. Ohio 1988) (trustee's appraisal not a ceiling, and because a free and clear sale under § 363(f)(3) had already occurred, a § 506(a) valuation was pointless).

⁵¹ *Gaglia v. First Fed. Savings & Loan* (*In re Gaglia*), 97 Bankr. 250, 251-52 (W.D. Pa. 1989); *In re Larsen*, 99 Bankr. 1 (Bankr. D. Alaska 1989) (collecting cases); *In re Shrum*, 98 Bankr. 995 (Bankr. W.D. Okla. 1989) (en banc); *In re Dewsnap*, 87 Bankr. 676 (Bankr. D. Utah 1988); *In re Maitland*, 61 Bankr. 130, 134 (Bankr. E.D. Va. 1986); *In re Cordes*, 37 Bankr. 582 (Bankr. C.D. Cal. 1984); *In re Mahaner*, 34 Bankr. 308 (Bankr. W.D.N.Y. 1983).

Mahaner seems to be the lead case. In *Mahaner*, an undersecured party moved for relief from the automatic stay. The debtor protested, because she wanted to make a motion under § 506(a) that

estate is a standard feature of the trustee's powers.⁵² The idea is that if a trustee avoids a lien, and there is a second lien creditor out there, avoidance should not provide the second lien creditor with a windfall promotion.⁵³ In order to make sure that only the general creditors benefit from lien avoidance by the trustee, Section 551 of the Bankruptcy Code preserves the lien for the benefit of the estate, so that it can be asserted on behalf of the estate, thereby keeping the second lien creditor in her place.⁵⁴ If this provision is used, then the trustee can obtain a low valua-

the security interests be valued and a motion under § 506(d) that the underwater portion of the lien be avoided. Then the debtor wanted to redeem the collateral (the family home) for the amount of the § 506(a) ceiling. The court lifted the stay on three grounds. First, it thought that a redemption statute already existed under 11 U.S.C. § 722 (1982). That provision is limited to a narrow range of household goods and similar exempt personal property. There was no warrant, the court thought, to make § 506(d) into another redemption statute for different kinds of property. *But see In re Gibbs*, 44 Bankr. 475, 478 (Bankr. D. Minn. 1984) (rejecting this argument and pointing out that § 722 applies only in Chapter 7, whereas § 506(d) applies in any of the Chapters); *see also* 11 U.S.C. § 1322(b)(2) (1982 & Supp. III 1985) (Chapter 13 plan may not affect the rights of a mortgagee of the debtor's residence); *In re Harris*, 94 Bankr. 832, 835-36 (D.N.J. 1989) (allowing § 506(d) avoidance in Chapter 13 in spite of § 1322(b)(2)); *In re Bruce*, 40 Bankr. 884 (Bankr. W.D. Va. 1984) (same, with regard to second mortgages, but indicating that Congress intended § 1322(b)(2) to protect first mortgagees from such treatment).

Second, the *Mahaner* court noted that if a § 506(d) motion were granted and if a lien were partially avoided, the lien would be preserved for the benefit of the estate. And if the lien were preserved for the benefit of the estate, the debtor could not personally gain from a continuation of the automatic stay; therefore, the stay should be lifted. Finally, the court thought that use of § 506(d) by the debtor might be unconstitutional because it amounts to a taking of a secured party's property without compensation. The easy answer to this constitutional challenge is that the Code routinely destroys liens, as under the voidable preference or fraudulent conveyance provisions. If there is a constitutional issue, it involves whether § 506(d) can retrospectively destroy liens created before 1978. *See Iowa Note, supra* note 37, at 448-49.

Nevertheless, if the debtor is also the trustee under Chapter 11 or Chapter 13, it is at least clear that the debtor has power to use § 506(d) to cap the undersecured party's claim to collateral. *But see* 11 U.S.C. § 1322(b)(2) (1982 & Supp. III 1985) (no modification of real estate mortgages allowed where collateral is the principal residence). What the cited cases are saying is that a debtor-in-possession may not use this power for self-serving reasons. Rather, the power may only be used to benefit general creditors. *But see In re Shrum*, 98 Bankr. 995, 1003 (Bankr. W.D. Okla. 1989) (Teselle, J.) (reading Bankruptcy Rule 3012 as giving any party in interest the right to request a § 506(a) valuation).

For some cases allowing a debtor-in-possession to use § 506(d) in a self-serving way, but also complaining that such a use is unfair, *see In re Worrell*, 67 Bankr. 16, 20 (Bankr. C.D. Ill. 1986); *In re Lyons*, 46 Bankr. 604, 606-07 (Bankr. N.D. Ill. 1985).

⁵² *See* 11 U.S.C. § 551 (1982); *see generally* Chobot, *Preserving Liens Avoided In Bankruptcy—Limitations and Applications*, 62 AM. BANKR. L.J. 149 (1988).

⁵³ *In re Appalachian Energy Indus., Inc.*, 25 Bankr. 515 (Bankr. M.D. Tenn. 1982).

⁵⁴ For example, suppose that collateral worth \$500 (if unencumbered) has two security interests on it—one securing A's loan for \$350 and one securing B's loan for \$800. Suppose also that A's lien is a voidable preference. If the trustee simply destroyed A's lien by avoiding it, then B gets a promotion, and the estate gets nothing. Instead, the trustee preserves the avoided lien for the benefit of the estate

tion of the collateral under Section 506(a), use Section 506(d) to avoid the underwater portion of any lien, and then enforce the preserved lien against the misvalued equity.

This strategy can be done in one of two ways. First, the trustee could abandon the property to surviving secured creditors, let them foreclose under state law, and take any cash surplus over the Section 506(a) ceilings established in bankruptcy.⁵⁵ Second, the trustee could retain jurisdiction of

and uses the lien to take \$350 for the general creditors. Meanwhile, *B* is neither helped nor harmed by the voidable preference action.

⁵⁵ There is an impediment to such a use of § 506(d). Because the trustee's theory depends entirely on preservation of the avoided lien for the benefit of the estate, close attention must be paid to the text of the lien-preserving statute:

Any transfer avoided under section 522, 544, 545, 547, 548, 549, or 724(a) of this title, or any lien void under section 506(d) of this title, is preserved for the benefit of the estate *but only with respect to property of the estate*.

11 U.S.C. § 551 (1982) (emphasis added). This Section of the Code specifically contemplates the preservation of liens avoided by § 506(d), but the italicized words are troublesome. The italicized words might mean that a lien can be preserved only so long as the debtor's equity is still part of the estate (Taken literally, the words can be read as totally nonconsequential. If an avoided lien is preserved, the lien itself is property of the estate, so that the lien is *always* preserved *with respect to property of the estate*. On this view, the italicized words are meaningless. But because Congress is presumed not to speak meaningless and empty words, such an interpretation is, regrettably, too simple.)

Reference to the Supreme Court opinion in which lien preservation was first discussed will clarify what the italicized words of § 551 might mean. In *First National Bank v. Staake*, 202 U.S. 141 (1905), a judgment creditor obtained a lien that would eventually become a voidable preference. Thereafter, the debtor sold the equity in the property to a third party. Later, the debtor filed for bankruptcy. *Id.* at 142-43. The Supreme Court allowed the trustee to avoid the judicial lien as a voidable preference, preserve it for the benefit of the estate, and then assert the avoided judicial lien against the third party's land. *Id.* at 144-49. If *Staake* is still good law, the trustee can avoid the underwater portion of the lien under § 506(d), abandon the land to the debtor or to the surviving secured creditors, and then assert the avoided lien against the equity that the bankruptcy court has undervalued.

A later court, however, has read the above italicized words in § 551 as overruling the exact holding of *Staake*. In *re Ward*, 42 Bankr. 946 (Bankr. M.D. Tenn. 1984). That is, if the bankrupt estate no longer owns the equity at the time of bankruptcy, no avoidable lien can be preserved against the collateral. This view is fatal to the trustee strategy I have just described in the text.

For better or worse, the view expressed in *Ward*—no lien preservation unless the estate owns the equity behind the preserved lien—is consistent with the words but not with the spirit of § 551. The legislative history indicates that the italicized words of § 551 were designed to prevent the trustee from asserting voided tax liens against post-petition property acquired by the debtor. 124 CONG. REC. H32,350 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards). The italicized language makes clear that the trustee may not avoid the lien and then preserve it against the debtor's post-petition property.

The legislative history, then, supports the view that the italicized language applies only when the property encumbered by an avoided lien is post-petition property. It has no application to property which the debtor cannot exempt but which the estate abandoned. On this view, the trustee can use § 506(d) to obtain a lien on undervalued property outside of bankruptcy and can arbitrage between bankruptcy valuations and market values of collateral.

the debtor equity and enforce the preserved lien against the bankrupt estate's own equity interest. Therefore, if this theory holds up, arbitraging by the trustee can occur by moving directly from Section 506(a) to a Section 363(f)(3) sale free and clear of liens, or by taking a detour through Section 506(d) avoidance. The difference between a straight arbitrage between Sections 506(a) and 363(f)(3), on the one hand, and the addition of Section 506(d), on the other, is purely formal. Without Section 506(d), the trustee receives the surplus by virtue of owning the equity. Thanks to Section 506(d), there is no valuable equity, but the trustee owns the junior lien which must get the surplus over \$450, the amount needed to pay off the valid secured claims of *A* and *B*. This possibility helps to prove that Section 506(a) valuations might well be final judgments after all.

C. *The Creditor's Right to Bid In*

Let us back track a bit and suppose that our preferred reading of the Code is true. That is, Section 363(f)(3) is read to prevent a sale unless the high bid exceeds the face amount of the secured claims. In addition, Section 506(a) valuations do not constitute a ceiling on undersecured creditor claims. Now the trustee cannot arbitrage between the valuation hearing and the actual sale.⁶⁸ That is, the Section 506(a) valuation is not an absolute ceiling on undersecured creditor entitlements under Chapter 7. Rather, Section 506(a) valuations have significance for voting and the like pending a 363(f)(3) sale, but not for the purpose of measuring the entitlement to the cash proceeds of a 363(f)(3) sale. Instead, the secured parties have a lien on cash proceeds for the face amount of their claims against the debtor. Using the numbers of our example, *A* and *B* each have a lien for \$350 on the cash, and the trustee may not sell unless the high bid is at

⁶⁸ The author of the Cardozo Note, *supra* note 29, at 1254, assumes that it is enough that the trustee is unable to sell collateral unless the sales price exceeds the face amount of the secured creditors' claims. However, this alone would not stop the arbitrage the author fears. Suppose, using our example, that *A* and *B* have claims of \$350, and that the collateral is worth only \$500 to its highest valuing user. Under this author's view, the sale cannot occur as administered by the trustee. The collateral must be abandoned to *A* and *B*. At state law, the § 506(a) limitations would not apply, so *A* and *B* would be fully protected, as the author hopes. But now suppose the trustee finds a buyer willing to pay \$750. Under the author's view, the trustee may now hold the sale, but the question still remains as to the entitlement to the cash proceeds. Unless one takes a relaxed view of the § 506(a) valuation (assumed to be \$450), the trustee might be able to pay *A* \$350, *B* \$100, and expropriate the rest. The trustee here *has* successfully arbitrated between the § 506(a) hearing and the actual auction. Therefore, full protection from such arbitrage requires a relaxed view of the § 506(a) limitation on the undersecured creditor's secured claim.

Incidentally, the author of the Cardozo Note assumes elsewhere that the "relaxed interpretation" of § 506(a) valuations is correct. Cardozo Note, *supra* note 29, at 1261-62.

least \$700.⁵⁷

Traditional maxims of legislative interpretation pose some problems with this view. For example, one is not suppose to read a section of the Code in a way that deprives another provision of all use and utility.⁵⁸ The above reading of Section 506(a) might transgress this rule. In Section 363(k), undersecured creditors are provided with a protection that would not be important unless Section 506(a) provides an otherwise immutable ceiling.⁵⁹ Section 363(k) provides:

At a sale . . . of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.⁶⁰

Reverting back to our hypothetical in which *B* has a claim for \$350 but only \$100 of which is thought to be secured, Section 363(k) ought to imply that, at the sale held by the trustee, *B* must pay in some cash—enough to make sure that *A*'s senior claim is covered. After that, *B* is free to bid in her \$100 secured claim and her \$250 unsecured claim. As a result, *B* bids \$501 and wins the auction (at which, we have stipulated, the high bidder

⁵⁷ Still, it cannot be true that § 506(a) poses no sort of ceiling at all. The following example will reveal why. Suppose *D* would like to file a Chapter 11 plan in which *A* (the senior fully secured creditor) receives payments on principal. If *B* (the junior undersecured creditor) has a right to whatever collateral is available to her at state law—i.e., § 506(a) never limits *B*'s claim—then every dollar paid to *A* increases *B*'s collateral entitlement. Some provision must be kept to allow *D* to pay *A* for the advantage of *D*'s general creditors. *Pitre v. First Federal Savings and Loan Ass'n of Chicago* (*In re Pitre*), 11 Bankr. 777, 781 (Bankr. N.D. Ill. 1981); 3 COLLIER ON BANKRUPTCY ¶ 506.04 at 506-19 (15th ed. 1985); UCLA Note, *supra* note 2, at 1962. Cf. *In re Rosage*, 82 Bankr. 389, 390 (Bankr. W.D. Pa. 1987) (suggesting that equitable subordination of the second mortgagee might be appropriate, at least where the first mortgagee was an insider).

There is a conceptually adequate way to achieve this result. In bankruptcy, where *A* and *B* both claim liens on property, and when *A*'s lien is voidable by the trustee for some reason, the voidable lien never just disappears. If it did, then *B* is the direct beneficiary of the trustee's avoiding power. Instead, the voided lien is preserved for the bankrupt estate, so that the trustee takes over *A*'s priority against *B*. 11 U.S.C. § 551 (1982). Similarly, when the trustee chooses to pay *A*, *A*'s lien should not be taken as disappearing. That would only benefit *B*. Instead, we should think of the trustee as buying an assignment of the lien, so that *A*'s priority is preserved for the estate.

⁵⁸ For a celebration of such reasoning, see *United Savings Ass'n. of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, — U.S. —, 108 S.Ct. 626, 632 (1988).

⁵⁹ *In re Terrace Gardens Park Partnership*, 96 Bankr. 707, 713 (Bankr. W.D. Tex. 1989) (reading § 363(f)(3) to allow a sale for less than the face amount of secured claims and connecting § 363(k) to abuse of § 363(f)(3)).

⁶⁰ 11 U.S.C. § 363(k) (1982 & Supp. IV 1986).

would have paid \$500 for the collateral). The \$501 price, however, can be paid in the form of \$350 cash (which goes to *A*), \$100 in the form of the allowed secured claim, and \$51 in the amount of the allowed unsecured claim (which had been \$250). Note that the \$250 unsecured claim is "funny money." In a bankruptcy in which general creditors are expected to get five cents on the dollar, the \$51 portion of the claim that *B* is allowed to bid in is really worth \$2.51, but thanks to Section 363(k), the claim is counted as if it were worth \$51.⁶¹

Before we show how Section 363(k) implies a "strict ceiling" view of Section 506(a), it is necessary to digress a little about the way Section 363(k) is written. The above paragraph sets forth a preferred interpretation of Section 363(k). It was assumed that *B* can not bid in her claims until *A* has been paid in cash. But nothing in Section 363(k) requires *B* to pay cash to *A* before the bid-in occurs.⁶² Nevertheless, such a cash requirement must be implicit in Section 363(k), as the following example illustrates.

Pursuant to the literal terms of Section 363(k), suppose *B* is allowed to bid in the claim, without paying in enough cash to pay off *A*. In such a case, *B* may pay in the \$100 secured claim first and the \$250 unsecured claim second. At this point, *B* has exhausted her claims, so that, to reach the high bid of \$501, *B* must add \$151 in cash. *A*, who has a senior claim to any proceeds from the sale, does not get a cash recovery for the full amount of her \$350 claim. Instead, *A* gets \$151 in cash, a secured claim against the collateral for \$100 (remember, the sale was free and clear of all liens, so *A* may be getting only a worthless paradox here), and an unsecured claim worth far less than the face value of \$100. This is no full recovery for *A*! It would have been better if Section 363(k) clearly stated that *B* gets to bid in her claims only after all sales expense and all senior secured claims are settled in cash. Only thereafter should *B* obtain the protection of bidding in unsecured claims worth a fraction of face value. Under this view, *B* would have to pay \$350 in cash, \$250 in secured claim, and \$51 in relatively valueless unsecured claim.

⁶¹ Some readers may be tempted to think that such a transformation of unsecured debt into valuable property rights is impermissibly preferential, privileging undersecured parties over general creditors. This is not a concern. Recall that we are addressing a gap between the appraised value and the true value of collateral. The gain enjoyed by the undersecured party represents a restoration to her of the value mistakenly denied her earlier. In other words, the gain constitutes no more than the correction of a valuation mistake.

⁶² In one case, a junior creditor was permitted to bid in without providing any details about paying off the senior creditors. *In re Miami Gen. Hosp., Inc.*, 81 Bankr. 682, 685 (S.D. Fla. 1988). Presumably, the junior secured party paid enough cash to pay off the senior secured parties.

We have just suggested that, under Section 363(k), *B* may bid in her secured *and* unsecured claims. There is yet another interpretation of Section 363(k) that, if adopted, might also imply strict ceilings in Section 506(a). This third interpretation of Section 363(k) is based on the fact that Section 363(k) allows *B* to bid in only her allowed secured claim.⁶³ Back to our example, suppose, at a Section 506(a) hearing, the bankruptcy judge values the collateral at \$450. The court has fully allowed *A*'s secured claim at \$350 and has divided *B*'s claim into a secured and unsecured portion (of \$100 and \$250 respectively). That is, *B* is a non-recourse claimant with an allowed secured claim of \$100 and an unsecured creditor for the balance. Now Section 363(k) implies that *B* may *only* bid in her "allowed secured claim" of \$100. If so, to win the auction, *B* must bid in the \$100 (which has a fair market value of \$100) and must pay \$401 in cash. Under this interpretation of Section 363(k), *B* is not permitted to bid in the valueless unsecured portion of her claim. Meanwhile, Section 506(a) valuations are assumed to be *final*.

Such a reading would mean that Section 363(k) bid-ins could not protect secured parties from bad valuations plus a free and clear sale under Section 363(f)(3). At first glance, this observation might be taken to prove that *B* can bid in her secured *and* unsecured claim. But remember that Section 363(f)(3) was assigned its pernicious anti-creditor meaning in order to render Section 363(k) bid-ins a useful protection. If Section 363(k) is *not* a useful protection, then perhaps we are free to adopt a non-pernicious meaning of Section 363(f)(3), where the trustee may never sell collateral unless she can obtain a price guaranteed to reimburse the se-

⁶³ Reviewing once again the confusing text of § 363(k), that section says: "At a sale . . . of property that is subject to a lien that secures an allowed claim, . . . the holder of *such* claim . . . may offset *such* claim against the purchase price of such property." 11 U.S.C. § 363(k) (1982 & Supp. IV 1986). "Such claim" refers to the allowed *secured* claim, under this reading. After a § 506(a) valuation, an undersecured party has *two* claims—only one of which is secured. *But see* *Geico Fin. Servs., Inc. v. Cordes* (*In re Cordes*), 37 Bankr. 582, 584 (Bankr. C.D. Cal. 1984) ("The language in § 363(k) refers to a lien secured by an allowed claim, not a lien secured by an allowed secured claim."). This remark from *Cordes* overlooks the fact that after a § 506(a) valuation, part of the claim is now completely unsecured. *Cf. In re Harris*, 94 Bankr. 832, 835-36 (D.N.J. 1989) (using this last observation to establish that § 506(a) can avoid the unsecured portion of mortgages on residences in spite of § 1322(b)(2)).

The requirement that a bidder have an "allowed secured claim" has led some litigants to insist that secured parties whose liens have not yet been judicially declared valid should not be allowed to bid in. Two courts have allowed bid-ins upon a showing that the bidder could reimburse the estate if the lien is later found to be void. *In re Miami Gen. Hosp., Inc.*, 81 Bankr. 682, 687-88 (S.D. Fla. 1988); *Bank of Nova Scotia v. St. Croix Hotel Corp.* (*In re St. Croix Hotel Corp.*), 44 Bankr. 277 (D.V.I. 1984).

cured party in full.

There is some legislative history, however, indicating quite clearly that *B* can bid in both her secured and unsecured claim:

[Section 363(k)] indicates that a secured creditor may bid in the full amount of the creditor's allowed claim, including the secured portion and any unsecured portion thereof in the event the creditor is undersecured, with respect to property that is subject to a lien that secures the allowed claim of the sale of the property.⁶⁴

It seems clear enough from *this* part of the legislative history that Section 363(k) was meant to allow undersecured creditors to bid in the unsecured portion of their claims.⁶⁵ But there is some contrary legislative history as well:

Throughout the bill, references to secured claims are only to the claim determined to be secured under [Section 506(a)], and *not to the full amount of the creditor's claim*. This provision abolishes the use of the terms "secured creditor" and "unsecured creditor" and substitutes in their places the terms "secured claim" and "unsecured claim."⁶⁶

Using this piece of legislative history on Section 363(k), it appears that the undersecured creditor can bid in only the secured portion of her claim. She may not bid the portion that is deemed by Section 506(a) to be fully unsecured. Therefore, it appears that the legislative history is inconclusive on the meaning of Section 363(k).

Under the view that the secured party can bid in only her fully valuable allowed secured claim, Section 363(k) ends up implying nothing about whether Section 506(a) is a strict ceiling against which a trustee can arbitrage. But under the view that Section 363(k) obviously allows the use

⁶⁴ 124 CONG. REC. H32,396 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); see also S. REP. NO. 598, 95th Cong., 2d Sess. 55, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5841; *In re Western Real Estate Fund, Inc.*, 75 Bankr. 580, 588 (Bankr. W.D. Okla. 1987); Cardozo Note, *supra* note 29, at 1271.

⁶⁵ One court has stated its belief that non-recourse lenders have the right to bid the underwater portions of their claims. *In re Realty Investments, Ltd. V.*, 72 Bankr. 143, 146 (Bankr. C.D. Cal. 1987). Most commentators ignore the point that after an undersecured claim is bifurcated under § 506(a), § 363(k) allows the undersecured creditor to bid in only her allowed secured claim. They assume without question that both the secured and unsecured portions of the debt can be bid in. 5 COLLIER ON BANKRUPTCY ¶ 1111.02[2] (15th ed. 1985).

⁶⁶ S. REP. NO. 598, 95th Cong., 2d Sess. 55, reprinted in 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 5841 (emphasis added).

of unsecured claims as scrip in a trustee auction, Section 363(k) protects any junior secured creditor who is willing to take control of the collateral. This protective device implies a particular view of Section 506(a) valuations. That is, a junior undersecured creditor requires protection under Section 363(k) only if Section 506(a) constitutes a strict and unvariable ceiling on her secured claim, and only if Section 363(f)(3) permits sales free of liens for amounts less than the total face amounts of the secured claims. Reverting again to the numbers of our hypothetical problem, if the trustee can only sell free of liens when the trustee obtains a bid of \$700, then *B* never needs to bid in pursuant to Section 363(k), because the \$700 minimum price guarantees either that *B* will be fully paid, or that the trustee will abandon the property so that the sale can be conducted under the auspices of state law. Therefore, the existence of the protection in Section 363(k) implies that Section 506(a) *does* create strict ceilings against which the secured party needs protection, and also that sales free and clear of liens can occur when the high bid is below the total claims of the secured parties claiming the collateral.

But having said this, there is still one further problem with this view that Section 506(a) valuations must be hard and fast ceilings because otherwise Section 363(k) has no purpose. Note that Section 363(k) does not limit bid-ins to sales free and clear of liens under Section 363(f)(3). It is possible that Section 363(k) applies in sales *subject to* outstanding liens. If this is right, Section 363(k) can have a purpose without Section 506(a) constituting a hard and fast ceiling on a secured party's entitlements.⁸⁷ It turns out, however, that such an extension of Section 363(k) produces impossible results and that Section 363(k) cannot apply to sales subject to outstanding liens. The following example will show why this must be true.

Suppose the trustee does not wish to sell under Section 363(f)(3). The trustee simply proposes to sell the debtor's equity in collateral to *X*, fully subject to the liens of *A* and *B*. If the sale goes through, *X* would be subject to the rights of foreclosure that *A* and *B* have under state law. Under state law, either *A* or *B* may enforce their (non-recourse)⁸⁸ claims

⁸⁷ Recall that, in our example, if § 506(a) is *not* a strict ceiling, then the trustee can sell the collateral only if she receives a bid higher than \$700. But if this is the case, then the § 363(k) bid-in can never take place. What I am now suggesting is that even if the trustee must receive a bid of \$700 to hold a free and clear sale, § 363(k) still has a purpose because it can apply to sales subject to (not free and clear of) liens.

⁸⁸ The claim must be non-recourse because *X* is not liable on the loan agreements between *D*, *A* and *B*. See *supra* note 10.

against *X*'s property. But suppose that, in bankruptcy, *B* may bid against *X* pursuant to Section 363(k). That is, while *X* bids cash, *B* bids her bankruptcy claims by way of setoff. Nothing in Section 363(k) expressly prevents *B* from doing this. If this is right, *B* need not even bid in the cash to pay off *A*, because *A*'s lien against the property survives against the collateral being sold. *B* may bid in just enough of her secured claim to outbid *X*. Suppose, for example, that the collateral was worth \$800 to *X*, so that *X* was willing to pay \$100 for *D*'s equity. This \$100 would not go to *A* or *B*, but to the bankrupt estate.⁶⁹ To win this auction, *B* must outbid *X*'s maximum bid of \$100. That is, *B* must bid \$100.01 of her allowed secured claim. On this bid, *B* buys the equity in the collateral, which merges with *B*'s security interest, so that *B* owns collateral encumbered by *A*'s lien, in exchange for which *B* surrendered her junior lien (\$100.01 by bidding and the rest through the doctrine of merger). Thus, *B* has a great competitive advantage over *X*. *X* must bid as if *A* and *B* will have surviving liens, whereas *B* may bid on the assumption that only *A* will have a surviving lien. If all of this were true, it would mean that Section 363(k) has a purpose beyond protecting *B* from sales free and clear of liens under Section 363(f)(3). That extra purpose is not to protect *B* at all but to enrich *B* in cases where the trustee wants to sell collateral subject to outstanding liens. If that is so, Section 363(k) can not imply a strict and unchangeable view of the Section 506(a) ceiling. What this really means is that Section 363(k) has yet another unstated assumption—it applies *only* to sales free and clear of liens under Section 363(f)(3). Section 363(k) should be a shield and not a sword. There is no compelling reason I can think of to enrich *B* when the trustee wishes to sell the debtor's equity. Instead, Section 363(k) should be read as allowing bid-ins *only* when the trustee proposes to sell free and clear of liens under Section 363(f)(3).⁷⁰ If

⁶⁹ Even this sensible conclusion is suspect. Under Article 9 of the U.C.C., the \$100 is proceeds on which both *A* and *B* have claims. U.C.C. § 9-306(1) (1987). Thus, *A* retains a lien against the collateral and obtains a senior right to any cash obtained in a foreclosure sale sponsored by a junior party. This two-for-one opportunity is a drafting mistake in Article 9. Cash proceeds from foreclosure sales should *not* be proceeds for the purpose of § 9-306(1). See Carlson, *Simultaneous Attachment of Liens on After-Acquired Property*, 6 CARDOZO L. REV. 505, 510 & n.29 (1985). But nothing in the Bankruptcy Code overrides this unfortunate effect of Article 9. If this is correct, then the trustee will have a great deal of difficulty ever selling the debtor's equity in collateral subject to outstanding liens (when the underwater junior lien is covered by Article 9).

⁷⁰ In 11 U.S.C. § 1129(b)(2)(A)(ii) (1988), one of the options for overcoming the objections of a secured party to a Chapter 11 plan (i.e., the cram down) is to hold a sale free and clear of liens and subject to a bid-in opportunity in § 363(k). This section does not prove that bid-ins are linked logically to a free and clear sale, but it does show that the drafters associated the two ideas together (at least in this one instance). The association may suggest that a logical or necessary connection also

so, and if you also think that an undersecured party may bid in the unsecured portion of her claim, then it must be true that Section 363(k) implies that the trustee must have an arbitrage opportunity under Section 363(f)(3), which in turn implies a strict view of the Section 506(a) ceiling.

Section 363(k), then, contains numerous hidden assumptions. Fortunately, the section also clearly states that a court may, for cause, alter the rules set forth in Section 363(k). Any one of the above bad results could easily be avoided if the court uses this invitation to temper Section 363(k) as literally written. If this is done, Section 363(k) can give effective relief against strict ceilings on entitlements imposed on an undersecured creditor under Section 506(a).

As we shall soon see, the Section 1111(b) election is itself another kind of relief from Section 506(a) ceilings. This time, however, the relief does not presuppose the existence of a Section 506(a) ceiling under Chapter 7. It only presupposes that without the election, the Section 506(a) ceiling freezes into place in a Chapter 11 plan. Prior to the plan, the ceiling might be ignored without affront or insult to the Section 1111(b) election. The election therefore can be viewed as relief from a Section 506(a) ceiling *in a Chapter 11 plan*. It need not imply a strict ceiling in a Chapter 7 liquidation. Let us stipulate that Section 506(a) valuations are final at least in Chapter 11,⁷¹ except for the protections to be found in Section 363(k) and, as we shall see, in Section 1111(b). This will allow us to look at how well the election works in conjunction with Section 363(k) bids to relieve undersecured creditors of the oppressive Section 506(a) ceiling.

We will need yet another short digression first. One of the substantive changes made by Chapter 11 turns non-recourse lenders into recourse lenders. The election must be understood against the background of this entitlement.

II. THE SECTION 1111(b) ELECTION

A. *Non-recourse Lenders Under Section 1111(b)*

Apart from the Section 1111(b) election, the section has a rule which is important for non-recourse undersecured creditors. Section 1111(b)(1)(A) provides:

exists.

⁷¹ Georgia Dev. Authority v. Home (*In re Home*), 99 Bankr. 132 (Bankr. M.D. Ga. 1989) (secured party could not have plan modified just because the collateral was more valuable than expected at a § 506(a) valuation hearing).

A claim secured by a lien on property of the estate shall be allowed or disallowed under section 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse. . . .⁷²

Now suppose a non-recourse lender advances \$1 million on collateral worth \$100,000. In the Chapter 11 plan, the non-recourse lender gets her secured claim for \$100,000 and a bonus as well—an unsecured claim for \$900,000. This provision is subject to two important exceptions.

First, if the Chapter 11 plan provides that the collateral is to be sold, the undersecured creditor is stuck with no recourse.⁷³ This disappointment is tempered by Section 363(k) which, if read carefully, permits the non-recourse lender to bid in the submarine portion of her claim when the trustee sells the collateral.⁷⁴ This relationship between Sections 363(k) and 1111(b) permits us to see the two sections as mutually exclusive protections for undersecured creditors. In fact, one court has held that *unless* the creditors are permitted to bid in, creditors without recourse under state law should get their recourse in bankruptcy, even if the plan calls for a sale of the collateral.⁷⁵ In the same vein, courts have held that non-

⁷² 11 U.S.C. § 1111(b)(1)(A) (1982).

⁷³ The plan must *specify* when the sale is to occur. Vague indications of some future sale are not enough to deprive non-recourse lenders of their recourse or of their right to make the election. *In re Georgetown Park Apartments, Ltd.*, 103 Bankr. 248, 249-50 (Bankr. S.D. Cal. 1989); *In re Western Real Estate Fund, Inc.*, 75 Bankr. 580, 589 (Bankr. W.D. Okla. 1987).

⁷⁴

The ability of the non-recourse lender to purchase its collateral at a sale, with a credit offset allowed for any bid up to the full amount of its debt, insures that the lender is protected. If the property is being sold for less than the outstanding indebtedness and the lender feels this price is too low or it feels future appreciation will be meaningful, it may bid the full amount of its debt at the sale and take title to the property. With this protection, the non-recourse secured lender does not need and therefore is not given the statutory protection of § 1111(b).

In re DRW Property Co., 57 Bankr. 987, 992 (Bankr. N.D. Tex. 1986).

⁷⁵ *In re Woodridge North Apts., Ltd.*, 71 Bankr. 189, 191 (Bankr. N.D. Cal. 1987). See also *John Hancock Mutual Life Ins. Co. v. California Hancock, Inc.* (*In re California Hancock, Inc.*), 88 Bankr. 226, 229-30 (Bankr. 9th Cir. 1988). In *California Hancock*, a debtor-in-possession proposed a Chapter 11 plan in which the equity in the collateral (worth nothing, because the collateral was substantially overencumbered) would be sold to an insider for a certificate promising the debtor-in-possession a share of the profits. The sale would not foreclose the undersecured party's security interest on the collateral.

The court refused to affirm the plan, because "the plan did not allow the appellee the right to credit bid." *California Hancock*, 88 Bankr. at 228. In addition, the court also ruled that the sale was not a sale, but a joint venture. Without an outright sale, the plan wrongfully denied the undersecured party its recourse under § 1111(b)(1)(A). *Id.*

Undoubtedly, this sale was fishy. The equity may have been worth nothing, but the receipt of

recourse lenders get no recourse if the plan calls for the abandonment of the collateral to the secured creditor.⁷⁶ If property is abandoned, then there will be foreclosure at state law, where bid-ins are allowed.⁷⁷

Second, the non-recourse lender obtains no recourse if the non-recourse lender is part of a class that elects application of Section 1111(b)(2). We still have not said what this election is about. For now, we can at least note that the creation of recourse for non-recourse lenders constitutes a bribe for classes of creditors who vote "no" in the election.⁷⁸

Why did Congress import such a strange metamorphosis of non-recourse debt into Chapter 11? One possible answer is that the Section 1111(b) remedy was written to gratify some real estate interests offended by *In re Pine Gate Associates*.⁷⁹ In *Pine Gate*, some non-recourse undersecured creditors were purchase money lenders financing the construction of some condominiums. In the middle of construction, the debtor filed for bankruptcy and successfully limited the secured claims of the construction lenders by the old equivalent of a Section 506(a) valuation hearing. Because the non-recourse secured lenders had a Section 506(a) ceiling placed on their claims, any gain in collateral value would go to general creditors

half the profits was no price at all. If there had been no sale, the debtor-in-possession would have retained all the profits. It gained nothing by losing the collateral and half the profits. Therefore, the court did well to deny that a sale had occurred.

⁷⁶ *Tampa Bay Assocs., Ltd. v. DRW Worthington, Ltd. (In re Tampa Bay Assocs., Ltd.)*, 864 F.2d 47, 50 (5th Cir. 1989); *In re DRW Property Co.*, 57 Bankr. 987, 992 (Bankr. N.D. Tex. 1986).

⁷⁷ If a sale is subject to liens or free and clear of liens, the non-recourse lender should get no recourse because both give the non-recourse lender a bid-in opportunity. We have said that § 363(k) applies only to free and clear sales. It does not apply to sales subject to surviving liens. Nevertheless, if a sale subject to liens has occurred, the undersecured party may foreclose against the non-recourse buyer, and the bid-in right can be applied.

You may be wondering, "Can't the debtor forestall foreclosure by paying off the secured party and thereby preventing an enforcement sale? If so, then no bid-in exists." Under Article 9 of the U.C.C., this is impossible. Property can be redeemed only if the buyer pays "all obligations secured by the collateral. . . ." U.C.C. § 9-506 (1987). This implies that an undersecured party must be paid in full, in which case the bid-in right is not needed. But this view is subject to yet another complication.

Remember that § 506(d) automatically limits a secured party to the amount of the § 506(a) ceiling, so long as a secured claim is filed in the bankruptcy case. See *supra* text accompanying notes 33-42. Therefore, "all obligations secured by the collateral" (U.C.C. § 9-506) may mean the § 506(a) ceiling and not more. If so, the bid-in is defeated after all, because the collateral can be redeemed for the amount of the § 506(a) ceiling.

⁷⁸ 11 U.S.C. § 1111(b)(1)(A)(i) (1982).

⁷⁹ 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976); see *General Electric Mortgage Corp. v. South Village Inc. (In re South Village, Inc.)*, 25 Bankr. 987, 999 (Bankr. D. Utah 1982) ("Section 1111(b) was designed to overrule *In re Pine Gate Associates*.").

and even to shareholders.⁸⁰ None of the gain could go to the non-recourse lenders. Therefore, one possible explanation for the recourse/non-recourse distinction in Section 1111(b) is that the drafters of the language, told to placate real estate lobbyists, took their task literally. They protected non-recourse lenders because non-recourse lenders were the ones who had been damaged in *Pine Gate*.⁸¹

B. Recourse Lenders Under Section 1111(b)

If Chapter 11 changes non-electing, non-recourse debt into recourse debt (where no sale of the collateral is planned), the obverse is not necessarily true, as courts and commentators routinely assume;⁸² that is, electing recourse lenders are not deprived of their recourse. This belief comes from the language of Section 1111(b)(1)(A) which, once again, provides:

⁸⁰ *Pine Gate*, 2 Bankr. Ct. Dec. (CRR) at 1487-91. Under old Chapter XII, the shareholders might benefit by a valuation freeze because Chapter XII did not follow the "absolute priority rule for dissenting creditors. 11 U.S.C. § 472(5) (1976) (repealed 1978). See *In re Pine Gate Assocs., Ltd.*, 3 Bankr. Ct. Dec. (CRR) 301, 307 (Bankr. N.D. Ga. 1977) (Norton, J.).

Ironically, the same judge who condoned a freeze-out of secured creditors in a Chapter XII plan also waxed indignant at the idea that a secured creditor should be frozen at liquidation value at the beginning of a bankruptcy proceeding. Instead, fairness required that the valuation take place at or near confirmation and at a higher going concern value. Furthermore, after valuing the property based on present value of future income, Judge Norton kicked up the valuation of the condos by twenty percent, just in case appreciation value might accrue. *Id.* at 308. Therefore, if secured creditors were enraged by *Pine Gate*, they overlooked some mitigating generosity from Judge Norton in his later opinion.

⁸¹ The transmutation of recourse debt into non-recourse debt works an extraordinary effect on buyers of collateral under Article 9. Article 9 invites a debtor to sell her equity in collateral to a buyer. U.C.C. § 9-311 (1987). Sometimes the sale itself destroys the security interest, as when the collateral is inventory. U.C.C. § 9-307(1) (1987). It is possible, however, that a buyer takes the collateral subject to a perfected security interest. In such a case, Article 9 is careful to treat the buyer as if he were a non-recourse debtor. U.C.C. § 9-112 (1987); see also U.C.C. § 9-105(1)(d) (1987) ("Where the debtor and the owner of the collateral are not the same person, the term debtor means the owner of the collateral. . . .").

Should the buyer file a petition under Chapter 11, the buyer's creditors will be surprised to learn that the lender of funds to some third party (who sold collateral to the buyer) now has a deficit claim against the buyer's bankruptcy estate, an extraordinary result. For example, suppose A has a \$1,000,000 claim against a debtor's personal property, worth only \$100,000. The debtor sells this property out of the ordinary course of business to X for \$1.00. X then files for Chapter 11 reorganization. In X's reorganization proceedings, A now has a recourse claim of \$900,000 in addition to the secured claim of \$100,000.

⁸² *In re Western Preferred Corp.*, 58 Bankr. 201, 210 (Bankr. N.D. Tex. 1985); *In re Union Square Assoc. Ltd.*, 53 Bankr. 532 (Bankr. E.D. Ark. 1985); *In re Southern Mo. Towing Serv., Inc.*, 35 Bankr. 313, 314 (Bankr. W.D. Mo. 1983); *In re Griffiths*, 27 Bankr. 873, 876 (Bankr. D. Kan. 1983); *Provident Bank v. BBT (In re BBT)*, 11 Bankr. 224, 231 n.12, 237 n.20 (Bankr. D. Nev. 1981); 5 COLLIER ON BANKRUPTCY ¶ 1111.02[5] (15th ed. 1985); Eisenberg, *The Undersecured Creditor in Reorganizations and the Nature of Security*, 38 VAND. L. REV. 931, 965 (1985).

A [secured] claim . . . shall be allowed or disallowed . . . the same as if the holder of such claim had recourse against the debtor . . . whether or not such holder has recourse, unless—

(i) the class of which such claim is a part elects . . . application of [Section 1111(b)(2)]⁸³

The typical implication drawn from the language of Section 1111(b)(1)(A)(i) is that the election negates recourse, but it is also possible to read this language as providing that the election negates only the opening clause of Section 1111(b)(1)(A). Once the opening clause is negated, then the basic rule of Section 502(b) applies. That is, those who have recourse as part of their non-bankruptcy rights continue to have it. Those who were non-recourse lenders lose the bonus that the first clause gives them; if non-recourse lenders make the election, they remain non-recourse lenders.

One commentator, Isaac Pachulski, finds in Section 1129(a)(7)(B) proof that recourse lenders forfeit their recourse when they make the Section 1111(b)(2) election. To assess this claim, it would be useful to set forth the entire text of Section 1129(a)(7), which provides that a Chapter 11 plan can be confirmed only if:

(A) each holder of a claim or interest of such class—

(i) has accepted the plan; or

(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date; or

(B) if section 1111(b)(2) of this title applies to the claims of such class, each holder of a claim of such class will receive or retain under the plan on account of such claim property of a value, as of the effective date of the plan, that is not less than the value of such holder's interest in the estate's interest in the property that secures such claims.⁸⁴

This, of course, is the famous "best interest of the creditors" test.

In accounting for the presence of Section 1129(a)(7)(B), Pachulski claims that it proves the notion that electing *recourse* lenders forfeit their recourse. According to this theory, Section 1129(a)(7)(B) cancels an effect

⁸³ 11 U.S.C. § 1111(b)(1)(A) (1982).

⁸⁴ 11 U.S.C. § 1129(a)(7) (1988).

that Section 1129(a)(7)(A) would otherwise have. Section 1129(a)(7)(A) requires that every creditor must receive at least as much from a Chapter 11 plan as she would have received in a liquidation. Section 1129(a)(7)(B) forecloses the possibility of the following argument by an electing secured party: (1) in Chapter 7, the secured party would have a recourse claim; (2) in Chapter 11, the plan that *denies* her recourse (pursuant to Pachulski's interpretation of the election) might give her less than she would have in Chapter 7 liquidation; (3) therefore, the plan cannot be confirmed.⁸⁵

If Pachulski's premise is correct, his point is clever. But if you believe that electing recourse lenders should *keep* their recourse, Section 1129(a)(7)(B) has a *different* purpose—simply to negate the idea that an electing secured creditor is entitled to receive 100 percent of her claim.⁸⁶ Notice that Pachulski assumes that Section 1129(a)(7)(A) does *not* apply to the unsecured deficit claims of electing undersecured creditors. Why does this follow? According to Section 506(a), an undersecured claim is to be divided into two separate claims. The election applies only to the *secured* portion. The unsecured deficit (of a *recourse* creditor) is not subject to the election. Therefore, it is possible to read Section 1129(a)(7)(B), not as an alternative, but as a supplement, to Section 1129(a)(7)(A). It does not necessarily prove that electing recourse lenders forfeit their recourse.

The legislative history is divided on this difficult point. Some of it refers only to the fact that an electing *non-recourse* lender loses the *recourse* that Section 1111(b)(1)(A) would otherwise supply. It does not hint that electing recourse lenders lose their recourse.⁸⁷ On the other hand, here is Congressman Don Edwards's statement:

One last point deserves explanation with respect to the admittedly complex subject of confirmation. Section 1129(a)(7)(C) [now Section 1129(a)(7)(B)] in effect exempts secured creditors making an election under 1111(b)(2) from application of the best interest of creditors test . . . [U]nder Section 1111(b)(2), the creditors are given an allowed secured claim to the full extent the claim is allowed and *have no unsecured deficit*. Since Section

⁸⁵ Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. REV. 925, 935 (1980).

⁸⁶ That is, in my view § 1111(b)(2) implies that the § 506(a) ceiling is cancelled, and § 1129(a)(7)(B) emphasizes that the electing creditor is entitled to no more than the value of the collateral in the Chapter 11 plan. Meanwhile, if the electing creditor is entitled to an unsecured deficit claim, this *separate* unsecured claim is still covered by § 1129(a)(7)(A).

⁸⁷ 124 CONG. REC. H32,350 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 CONG. REC. H28,257 (daily ed. Sept. 7, 1978) (statement of Rep. Edwards).

1129(b)(2)(A) makes clear that an electing claim need receive payment of a present value only equal to the value of the collateral, it is conceivable that under such a "cram down" the electing creditors would receive nothing with respect to their deficit. The advantage to the electing creditors is that they have a lien securing the full amount of the allowed claim so that if the value of the collateral increases after the case is closed, the deferred payments will be secured claims. Thus it is both reasonable and necessary to exempt such electing class from application of Section 1129(a)(7) as a logical consequence of permitting election under Section 1111(b)(2).⁸⁸

Here Congressman Edwards *does* state the view that recourse creditors forfeit their recourse if they elect. For this reason, only the part of the cram down statute that applies to *secured* creditors need be met. There is no need to meet Section 1129(b)(2)(B), which pertains to cram down of *unsecured* creditors. Hence, at least this part of the legislative history supports Pachulski's theory of Section 1111(b).

With this background knowledge about non-recourse and recourse undersecured creditors under Chapter 11, we can proceed to an analysis of who may elect under Section 1111(b) and what the election means.

C. *Eligibility to Elect Under Section 1111(b)*

The Section 1111(b) election protects undersecured creditors from the limits of Section 506(a) valuations imposed in a Chapter 11 plan. Section 1111(b) is an alternative to Section 363(k) which, if read creatively, protects undersecured creditors, who can bid in the portions of their claims that appeared to be unrecoverable as a result of a low Section 506(a) valuation. Curiously, voter registration for the Section 1111(b) election is limited to the following types of undersecured creditors: (a) undersecured creditors (recourse or non-recourse) if the Chapter 11 plan does not call for sale of the collateral,⁸⁹ or (b) where a sale is planned, any *non-recourse* undersecured creditor.⁹⁰ Each of these classes is further purged whenever, in a Section 506(a) valuation, the secured portion of the undersecured creditor's claim has an "inconsequential value."⁹¹ The Section

⁸⁸ 124 CONG. REC. H32,408 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards) (emphasis added).

⁸⁹ This follows by negative implication of 11 U.S.C. § 1111(b)(1)(B)(ii) (1982), which provides that the election is not available if "the holder of a claim of such class has recourse against the debtor on account of such claim and such property is sold under Section 363 of this title or is to be sold under the plan."

⁹⁰ *Id.* (also by negative implication).

⁹¹ "A class of claims may not elect . . . if—(i) the interest on account of such claims of the

1111(b) election, then, is not for wishful-thinking creditors who are completely underwater with respect to their liens.⁹²

Do these restrictions on electoral eligibility make sense? Regrettably, no. There is no good reason to give non-recourse lenders an election when collateral is to be sold, if Section 363(k) is read correctly. Eliminating the election in *all* cases when the collateral is to be sold⁹³ would have made some sense, because those creditors can beat the limitations in Section 506(a) by bidding in their claims under 363(k).⁹⁴ Under this view, Sections 363(k) and 1111(b) could have been characterized as mutually exclusive alternative relief from strict Section 506(a) ceilings. Unfortunately, such a vision of symmetrical order and coherence is denied to us. If a sale is held, only recourse lenders are barred from the election. Non-recourse lenders may still go ahead with the election.

This distinction between recourse and non-recourse lenders is not comprehensible. One might be tempted to say that when a sale is planned, Section 363(k) does not help non-recourse lenders, so that the election in such cases is still necessary. Yet Section 363(k), if it defeats Section 506(a) ceilings at all, should do so for both recourse and non-recourse lenders. Therefore, availability of Section 363(k) protection cannot justify the recourse/non-recourse distinction.⁹⁵ Because the distinction cannot be justified, one court has stated summarily that if the Chapter 11 plan includes a sale, non-recourse undersecured creditors may not elect.⁹⁶ One author concurs that no election is ever allowed if the collateral is to be sold. The basis of this argument is the following legislative history:

Sale of property under Section 363 or under the plan is excluded from

holders of such claims in such property is of inconsequential value. . . ." 11 U.S.C. § 1111(b)(1)(B) (1982).

⁹² Nevertheless, even if non-recourse creditors who are completely underwater may *not* elect, they may still enjoy the transmutation of their non-recourse claims into recourse claims. *In re Atlanta West VI*, 91 Bankr. 620, 623 (Bankr. N.D. Ga. 1988).

⁹³ Of course, § 1111(b) does not do this. It only eliminates the election for *recourse* lenders. In case of a sale, the non-recourse lender may still elect.

⁹⁴ This was the rationale articulated in congressional debates. 124 CONG. REC. H32,407 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 5 COLLIER ON BANKRUPTCY ¶ 1111.02(3) at 1111-22-24 (15th ed. 1985).

⁹⁵ Recall that under one of the views of § 363(k), undersecured creditors can bid in only their "allowed secured claims." Under this interpretation, the § 1111(b) election becomes necessary to protect non-recourse lenders in case of a sale. But *recourse* lenders would be in the same position under such an interpretation of § 363(k), and they would need protection under § 1111(b) just as much. Therefore, nothing can be induced about the meaning of § 363(k) from the recourse/non-recourse distinction in § 1111(b)(1)(A)(ii).

⁹⁶ *In re Realty Investments, Ltd. V*, 72 Bankr. 143, 145 (Bankr. C.D. Cal. 1987) (*in dicta*).

treatment under Section 1111(b) because of the secured party's right to bid in the full amount of his allowed claim at any sale of the collateral under Section 363(k). . . .⁹⁷

The argument is that the broad reference to Section 1111(b) (and not to its subparts) shows congressional intent that the election is never available when the property is to be sold. Under this reasoning, if a sale is planned, non-recourse lenders cannot elect,⁹⁸ and the Section 1111(b) election looks more clearly like an alternative to Section 363(k) bid-in protection for Chapter 11 cases which contemplate no sale of any collateral.⁹⁹ This argument, though rational, does not jive very well with Section 1111(b)(1)(B), which provides:

A class of claims may not elect application of [Section 1111(b)(2)] if . . . (ii) the holder has recourse against the debtor . . . and such property is sold under Section 363 of this title or is to be sold under the plan.¹⁰⁰

This language clearly indicates that non-recourse creditors may have their election, whether or not the property is to be sold.

In any case, if a reorganization contemplates no sale—rather it contemplates an ongoing business with the use of collateral in the business—no creditor can beat the Section 506(a) ceiling by use of Section 363(k), which depends on a sale for the setoff power to be exercised. Therefore, in such cases, both recourse and non-recourse creditors are entitled to the election.

Finally, we have said that the Section 1111(b) election may not be made by any creditor who comes up with an “inconsequential” secured claim in the Section 506(a) valuation. In our example, where *A* and *B*

⁹⁷ 124 CONG. REC. H32,407 (daily ed. September 28, 1978) (statement of Rep. Edwards); 124 CONG. REC. S17,420 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini).

⁹⁸ This argument is developed in Stein, *Section 1111(b): Providing Undersecured Creditors with Postconfirmation Appreciation in the Value of the Collateral*, 56 AM. BANKR. L.J. 195, 210-12 (1982).

⁹⁹ If no election is allowed (for recourse lenders) when a sale of the collateral is planned, it should likewise follow that no election should be allowed when the trustee elects to *abandon* the collateral. After abandonment, undersecured creditors would enjoy under state law similar protection to that supplied by § 363(k) of the Code. At least one court, however, has ruled to the contrary. In fact, it ruled that electing creditors could *prevent* the trustee from abandoning altogether! *In re Griffiths*, 27 Bankr. 873 (Bankr. D. Kan. 1983). Because this view is dependent upon the court's interpretation of the substance of the § 1111(b) election itself, analysis of this position is deferred until the nature of the election has been laid out. See *infra* text accompanying notes 110-137.

¹⁰⁰ 11 U.S.C. § 1111(b)(1)(B)(ii) (1982).

have \$350 claims and where the collateral is valued at \$450, *B* would have a "consequential" secured claim and hence would be entitled to a Section 1111(b) election, if she is otherwise qualified. But suppose a third mortgagee, *C*, exists with a \$350 claim. The court in a Section 506(a) hearing would award *C* a \$350 unsecured claim and a zero secured claim. Such a person would be excluded from the election.¹⁰¹

This does not appear to be fair. The type of evil in *Pine Gate* might well involve the existence of a *C* who is completely underwater. The ceiling in Section 506(a) hurts *C* even more than it hurts *B*, yet *C* is denied the protection of the Section 1111(b) election. Fortunately, *C* is entitled to the protection in Section 363(k), so that, if a sale free and clear of liens is contemplated, *C* does not need the election. Therefore, if *C* is in a position to bid in her claim, *C* is prejudiced only in the case where no sale is contemplated.

D. *What the Election Does*

To summarize the immensely complicated discussion in the preceding pages, if the collateral is not to be sold, the Section 1111(b) election is available to any secured creditor who is not completely under water. If a sale is contemplated, only non-recourse secured lenders may elect. We have not yet said *what* they may elect. It is about time we did so, to the extent this can be done.¹⁰²

¹⁰¹ See *In re Rosage*, 82 Bankr. 389 (Bankr. W.D. Pa. 1987) (where lien was completely underwater, undersecured creditor could not elect); *In re Wandler*, 77 Bankr. 728 (Bankr. D.N.D. 1987) (a secured/unsecured split of 4%/96% made secured claim "inconsequential," barring secured party from election); *In re Baxley*, 72 Bankr. 195, 198-99 (Bankr. D.S.C. 1986) (A secured/unsecured split of 8%/92% was "consequential," and the election was allowed). If we may take the borderline to be between 4% and 8%, it should be remembered that accruing interest of senior secured parties will tend to lower the percentage that the junior secured parties are secured, thereby rendering the value of the secured claim "inconsequential." *In re Baxley*, 72 Bankr. at 197-98 (allowing senior interest and collection fees to accrue in spite of the election). However, adequate protection should preserve the original split. See also *In re Century Glove, Inc.*, 74 Bankr. 958, 962 (Bankr. D. Del. 1987) (Chapter 11 plan may not destroy election rights by manipulating the ratio between the secured and unsecured claim).

¹⁰² As to *when* they must elect, Bankruptcy Rule 3014 provides that it may be done "at any time prior to the conclusion of the hearing on the disclosure statement or within such later time as the court may fix." FED. R. BANKR. P. 3014. See *In re Rosage*, 82 Bankr. 389 (Bankr. W.D. Pa. 1987); see also *In re Century Glove, Inc.*, 74 Bankr. 958, 961 (Bankr. D. Del. 1987) ("a secured creditor class must know the prospects of its treatment under the plan before it can intelligently determine its rights under § 1111(b)").

This timing rule is a tricky matter. As indicated by Rule 3014, drafters of the Chapter 11 plan will have difficulty coping with the electoral powers of the secured party, because the disclosure hearing already presupposes that the Chapter 11 plan has been drafted. See 11 U.S.C. § 1125 (1982 &

1. "To the Extent Such Claim is Allowed"

Suppose *A* is a non-recourse lender of \$1,000,000 to the debtor. The collateral is worth \$100,000. There are no other liens on the collateral but *A*'s. *A* therefore faces a Section 506(a) ceiling of \$100,000. A sale of the collateral free and clear of liens is planned. If *A* makes the election in Section 1111(b)(2), *A* knows that, "notwithstanding Section 506(a)," she will have a secured claim "to the extent that such claim is allowed."¹⁰³ The Section 1111(b) election presupposes that we know to *what* extent *A*'s claim is allowed.

It turns out that the definitional machinery of the Code has a peculiar gap. If the non-recourse lender files a claim in a Chapter 11 proceeding, then Section 1111(b)(1)(A) applies to determine the "extent" to which the non-recourse lender has an allowed claim.¹⁰⁴ According to Section 1111(b)(1)(A):

A claim secured by a lien on property of the estate shall be allowed or disallowed under [S]ection 502 of this title the same as if the holder of such claim had recourse against the debtor on account of such claim, whether or not such holder has such recourse. . . .¹⁰⁵

Applying this language to our example, it now appears that *A* has an

Supp. III 1985). Before Rule 3014 was drafted in 1983, one court suggested that "alternate plans should be filed" whenever a secured party with election powers is involved. *Provident Bank v. BBT (In re BBT)*, 11 Bankr. 224, 237 n.20 (Bankr. D. Nev. 1981); see *In re Executive House Assocs.*, 99 Bankr. 266, 280 (Bankr. E.D. Pa. 1989) (alternative plans proposed). However, the *BBT* court's suggestion offers no resolution. As a trio of recent commentators have suggested, "[i]f there are just five separately classified secured claims that could elect, there are twenty-five possible combinations of elections. Debtors have enough difficulty filing a single plan, let alone twenty-five plans. . . ." Putsateri, Swartz & Shaiken, *Section 1111(b) of the Bankruptcy Code: How Much Does The Debtor Have to Pay and When Should the Creditor Elect?* 58 AM. BANKR. L.J. 129, 130 n.7 (1984). These authors assume that coordination between electing secured parties and debtors-in-possession will occur informally. *Id.* at 142 & n.78 ("The key to [C]hapter 11 is communication outside the courtroom. . ."). Accord *In re Western Real Estate Fund, Inc.*, 83 Bankr. 52, 55-56 (Bankr. W.D. Okla. 1988) (well informed creditor could not rely on failure of debtor-in-possession to set election deadline and could not elect after plan was confirmed). Another commentator suggests that the undersecured creditor file a written request for both a copy of the disclosure statement and notice of the hearing on the statement. FED. R. BANKR. P. 3017(a). This combination would produce "a copy of the plan several weeks prior to the expiration of the deadline for making the § 1111(b) election." LOPUCKI, *STRATEGIES FOR CREDITORS IN BANKRUPTCY PROCEEDINGS*, 492-93 (1985).

¹⁰³ 11 U.S.C. § 1111(b)(2) (1982).

¹⁰⁴ 11 U.S.C. § 1111(b)(2) (1982) ("If such an election is made, then notwithstanding Section 506(a) of this title, such a claim is a secured claim *to the extent that such claim is allowed.*") (emphasis added).

¹⁰⁵ 11 U.S.C. § 1111(b)(1)(A) (1982).

allowable claim of \$1,000,000, not just the \$100,000 awarded in the Section 506(a) valuation. Only \$100,000 of this is secured; the rest is an unsecured claim for \$900,000. But this extension of the allowable claim is subject to a remarkable self-contradictory exception. According to Section 1111(b)(1)(A)(i), *A* does not enjoy this expansion of her claim from non-recourse to recourse if:

the class of which such claim is a part elects, by at least two-thirds in amount and more than half in number of allowed claims of such class, application of paragraph (2) of this subsection.¹⁰⁶

Let us make it easy and assume *A* is a one-person class, as is usually the case for secured creditors under Chapter 11.¹⁰⁷ If *A*, a non-recourse lender under non-bankruptcy law, elects, *A* loses her right to recourse. Furthermore, the election means that *A* is entitled to be treated as secured to the extent of her *allowed* claim. Recall that her claim must be allowed on a non-recourse basis, meaning that it is limited to the value of the collateral. This seems to defeat *A* utterly and lead to the implication that *A* is entitled to the same \$100,000 that *A* received in the Section 506(a) valuation. Under this view, the election is meaningless. *A* escapes the Section 506(a) ceiling only under the provisions of Section 363(k) and not through any help that the election can give. *A* is better off not electing and instead obtaining recourse for the balance of \$900,000.¹⁰⁸

¹⁰⁶ *Id.*

¹⁰⁷ See *In re Hallum*, 29 Bankr. 343 (Bankr. E.D. Tenn. 1983) (holding that single-class lenders can make the election). For secured parties who prefer a recourse unsecured claim in lieu of whatever the election gives them, a single-member class for the unsecured claim has been ruled inappropriate. *In re Meadow Glen, Ltd.*, 87 Bankr. 421, 426-27 (Bankr. W.D. Tex. 1988). The *Meadow Glen* court thought that such single member classes dilute the power of non-recourse lenders to influence the class of unsecured creditors to which they would otherwise belong. *Id.* This would be so in one circumstance in particular. Section 1129(a)(10) requires at least one impaired class of creditors to vote yes on the plan. If the recourse claim is added to the class of general creditors, perhaps it could prevent that class from voting yes. If no other class has voted yes, then the recourse creditor can block confirmation of the plan. If § 1129(a)(10) is clearly met regardless of classification, a good argument can be made that a non-recourse lender's unsecured deficit claim is more powerful in its own class than it is in a class with other unsecured creditors. Within its own class, the non-recourse lender can guarantee for itself that the class will vote no and thereby obtain the protection of the absolute priority rule in cram down. See 11 U.S.C. § 1129(b)(2)(B)(ii) (1988).

For a case allowing the recourse claim to be classified separately from trade creditors (who were prepared to vote for the plan and thereby satisfy § 1129(a)(10)), see *In re Greystone III Joint Venture*, 102 Bankr. 560, 568-72 (Bankr. W.D. Tex. 1989).

¹⁰⁸ This point is *not* limited to non-recourse lenders, because most authorities believe that even *recourse* lenders lose their recourse if they make their election. I have argued that recourse lenders do *not* lose their recourse. See *supra* text accompanying notes 72-87.

This interpretation obviously reads the Section 1111(b) election right out of the Code (which, come to think of it, might not be a bad thing). However, for those who think each statutory word must have its purpose, we have at least demonstrated that, without a doubt, Section 1111(b) can not be read too literally. Instead, creative interpretation is needed to give A some protection from the Section 506(a) ceiling through the Section 1111(b) election.

2. *The Orthodox Interpretation of the Election*

No writers have noticed the circular definition of allowable claims in Section 1111(b). Instead, they have skipped this analysis and jumped right to the assertion of some positive content in Section 1111(b). Here is a common meaning attributed to the election:

Upon making an 1111(b) election a creditor . . . has the right to receive the full amount of its allowed claim over time, as long as these payments have a present value as of the effective date of the plan, of at least the value of the creditor's interest in its collateral.¹⁰⁰

Under this formulation, the election requires that total cash payments over time to A must equal \$1,000,000, but that the present value of those time payments need only equal \$100,000. In other words, it is open for a debtor-in-possession to pay the \$1,000,000 over *any* period of time, so long as the discounted value of the payments has a present value of \$100,000. In this reading, the economic value of the election can always be defeated by debtors-in-possession who extend cash payments out long enough to equate present value of the income stream with present value of the collateral. What good is the election then? It still leaves the under-secured creditor with the Section 506(a) ceiling, and the right to receive

¹⁰⁰ *In re Wandler*, 77 Bankr. 728, 732 (Bankr. D.N.D. 1987); see also *In re Kvamme*, 93 Bankr. 698, 699-700 (Bankr. D.N.D. 1988); 5 COLLIER ON BANKRUPTCY ¶ 1111.02[5] (15th ed. 1989). Pusateri, Swartz & Shaiken, *supra* note 102, at 136; Stein, *supra* note 98, at 202. This view is solidly backed by some legislative history which gives the following example:

For example, if a creditor loaned \$15 million to a debtor secured by real property worth \$18 million and the value of the real property had dropped to \$12 million by the date when the debtor commenced a proceeding under Chapter 11, the plan could be confirmed notwithstanding the dissent of the creditor as long as the lien remains on the collateral to secure a \$15 million debt, the face amount of present or extended payments to be made to the creditor under the plan is at least \$15 million, and the present value of the present or deferred payments is not less than \$12 million.

124 CONG. REC. H32,407 (daily ed. September 28, 1978) (statement of Rep. Edwards); 124 CONG. REC. S17,421 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini).

total compensation over time is completely unimportant. The rational secured party looks at the value of what she gets now. The length of the payout is economically insignificant.

There are two sorts of reasons asserted for making the Section 1111(b) election. First, it has been asserted that undersecured creditors affirmatively want long payouts because the long payout implies that the secured party cannot be cashed out immediately with a lump sum payment equal to the Section 506(a) ceiling. Second, it has been asserted that the benefits of the election are only felt upon default. Each of these orthodox rationales will be explored in turn.

a. Long Payouts

The first claim is that the election forces long payouts in lieu of lump sum cashouts.¹¹⁰ For example, if an electing secured party claims \$1,000,000 on \$100,000 worth of collateral, the election requires either that the secured party get \$1,000,000 of cash now, or \$1,000,000 over many years.¹¹¹ The theory is that if the debtor-in-possession has rid itself of the undersecured creditor with cash, it could freely expropriate the increase in collateral value for itself. Therefore, the long payout forces the debtor-in-possession to keep the electing undersecured creditor around.¹¹²

The motive behind this rationale is well-meaning, but it does not follow that a long payout is needed to reserve for an undersecured party any future appreciation in value of the collateral. There is no reason why the secured party could not be given immediate cash for the present value of the collateral, plus more cash later, if the collateral actually does appreciate. In any case, because payment can be stretched out so that the present value of the payments equals the present value of the collateral, long payouts make no great economic sense.

This view that long payouts are affirmatively desirable led the court in *In re Griffiths*¹¹³ to declare that a major meaning of the election is to

¹¹⁰ *In re Southern Mo. Towing Serv., Inc.*, 35 Bankr. 313, 314 (Bankr. W.D. Mo. 1983); Fortgang & Mayer, *Valuation In Bankruptcy*, 32 UCLA L. REV. 1061, 1115 (1985); Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 AM. BANKR. L.J. 113, 161 (1979).

¹¹¹ See BROUDE, REORGANIZATIONS UNDER CHAPTER 11 OF THE BANKRUPTCY CODE § 13.02 (1988).

¹¹² Thus, in *In re Kvamme*, 93 Bankr. 698, 699-700 (Bankr. D.N.D. 1988), a plan was rejected by the court because the plan provided for only a fifteen year payout and hence did not generate enough dollars over time to equal the full amount of the secured claim.

¹¹³ 27 Bankr. 873, 876-77 (Bankr. D. Kan. 1983).

prevent the debtor-in-possession from abandoning property that the creditor wants the debtor-in-possession to retain. Such an anti-abandonment policy also makes no sense. Because the electing creditors were undersecured in *Griffiths*, a sale would not have benefited the general creditors. The debtor-in-possession could keep the property and invest in improvements, but any increase would also go to the electing undersecured creditor. Therefore, the debtor-in-possession is forced to deal with the property even when the general creditors would not benefit thereby.¹¹⁴

A later case, *In re Elijah*,¹¹⁵ interprets *Griffiths* to mean that abandonment is prohibited only when the undersecured claim is not paid in full—that is, both the secured and unsecured portion. But when the secured party is expected to be paid in full—that is, the creditor is *oversecured*—then abandonment is permitted. This observation is both correct and trivial. If the secured party is oversecured, there is certainly no need to make the election. At a minimum, it must be true that abandonment is allowed in cases where the secured party enjoys an equity cushion. In *Elijah's* Chapter 11 plan, the undersecured creditor was to receive part of its collateral and cash for the balance, which, if the collateral were valued correctly, would satisfy 100 percent of the undersecured party's claim.¹¹⁶ For this reason, abandonment was allowed with the understanding that if the undersecured party received less than the estimated value of the collateral under state law proceedings, the debtor-in-possession would make up the difference with cash.¹¹⁷

A better mode of reconciliation is available than the one proposed by the *Elijah* court. In *Griffiths*, the debtor-in-possession proposed to abandon part and retain part of the collateral. For the part retained, the debtor-in-possession proposed to cash out the secured party exactly like the secured party in *Pine Gate*.¹¹⁸ Therefore, unless all collateral is abandoned, it should still be possible to make the election. Under the meaning of the election to be proposed in this article, the consequence of the election would be to repeal the limits of the Section 506(a) valuation with regard to the part of the collateral retained.¹¹⁹

¹¹⁴ The *Griffiths* case is defended in Waas, *Letting the Lender Have It: Satisfaction of Secured Claims by Abandoning a Portion of the Collateral*, 62 AM. BANKR. L.J. 97, 105-06 (1988).

¹¹⁵ 41 Bankr. 348, 351 (Bankr. W.D. Mo. 1984).

¹¹⁶ *Id.*

¹¹⁷ *Id.* at 352.

¹¹⁸ *In re Griffiths*, 27 Bankr. 873, 876-77 (Bankr. D. Kan. 1983). See *In re Pine Gate Associates*, 2 Bankr. Ct. Dec. (CRR) 1478 (Bankr. N.D. Ga. 1976); see also text accompanying notes 79-81.

¹¹⁹ Thus, in *Griffiths*, the undersecured party's claim would be reduced by whatever the under-

The availability of election in cases of total abandonment, however, seems questionable. It will be recalled that recourse lenders could not elect *at all* when the plan called for a sale. One of the reasons given for this ineligibility is that when the property was to be sold, the undersecured party could protect herself by bidding in under Section 363(k). In the case of abandonment, the lender will likewise have bid-in protection under state law. Therefore, it would be logical for lenders to have no election rights in abandonment cases. Yet the stated rationale of *Griffiths*, which does not even seem economically useful, does quite the opposite, in order to preserve an extended payout for undersecured creditors.

b. *Default*

A second explanation as to why the election pays is described in *In re Wandler*¹²⁰ and goes as follows:

The real value of a Section 1111(b) election is where the collateral appreciates in value and the debtor defaults under the plan [citation omitted]. Then instead of having a secured claim based upon the value of the collateral at confirmation, with the remaining debt having received unsecured treatment and/or discharged, the creditor may foreclose on the collateral and recover up to the full amount of its claim.¹²¹

In other words, the election repeals the Section 506(a) ceiling in case of default. If the plan holds, the ceiling stays in effect and becomes the guide for how much present value the undersecured creditor should receive under the plan, but if the plan fails (as many do) the creditor who elects can capture cash proceeds from the collateral in excess of the Section 506(a) ceiling. At least this part of the interpretation of Section 1111(b)(2) makes good sense. In my proposed alternative reading, it will still be true that, in case a plan falls apart, the secured party can pursue the collateral as if no Section 506(a) ceiling were in effect.¹²² I will be

secured party realized on the abandoned property. The reduced bankruptcy claim would then be made subject to the election with regard to the retained collateral.

¹²⁰ 77 Bankr. 728 (Bankr. D.N.D. 1987); see also *In re Southern Mo. Towing Serv., Inc.*, 35 Bankr. 313, 314 (Bankr. W.D. Mo. 1983).

¹²¹ 77 Bankr. at 732; *In re Mahaner*, 34 Bankr. 308, 309 (Bankr. W.D.N.Y. 1983); see also LoPUCKI, *supra* note 102, at 491.

¹²² This view also has the support of the legislative history, if one reads carefully:

If Section 1111(b)(2) applies then the "electing" class is entitled to have the entire amount of debt . . . secured by a lien even if the value of the collateral is less than the amount of the debt. . . . For example, if a creditor loaned \$15,000,000 to a debtor secured by real

going further to suggest that the meaning of the election is to repeal the Section 506(a) ceiling in all respects.

The author of a comprehensive theory of Section 1111(b), Jeffrey Stein, agrees with the above theory of the election's utility, but he would add that the utility of the election comes not only when the plan collapses. It also occurs when the debtor-in-possession, while still meeting the plan, changes her mind and sells collateral that initially was not to be sold. If a sale occurs under either scenario—plan failure or plan continuance—the electing creditor is entitled to the proceeds “up to the full amount of the debt.”¹²³ Therefore, Stein believes that, *in case of sale but not otherwise*,¹²⁴ the Section 506(a) ceiling is repealed for the electing secured party. The election does not guarantee the electing secured party a full recovery on her claim. Stein equates the election as adding a “due on sale” clause to the security agreement between the electing secured party and the debtor-in-possession.¹²⁵

The Collier treatise seems to take an even more extreme position. It goes beyond the view that the Section 506(a) ceiling is eliminated when the plan falls apart. Not only must the undersecured creditor get the full

property worth \$18,000,000 and the value of the real property had dropped to \$12,000,000 by the date when the debtor commenced a proceeding under Chapter 11, the plan could be confirmed notwithstanding the dissent of the creditor as long as the lien *remains on the collateral* to secure a \$15,000,000 debt. . . .

124 CONG. REC. H32,407 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards) (emphasis added). The first sentence sounds as if the undersecured creditor should get \$15,000,000 of old and new collateral, but the second sentence makes clear that it suffices if the undersecured creditor retains a lien on the collateral she originally had. The latter idea implies that if the plan collapses and the real estate is still only worth \$12,000,000, the undersecured creditor gets only \$12,000,000. Cf. the view of the Collier treatise, according to which she would get a guaranteed \$15,000,000 if the plan collapses (but less if the plan survives). See *infra* text accompanying note 127.

¹²³ Stein, *supra* note 98, at 212. Stein also believes that the election may be made only in cases when no sale of the collateral is planned. See *supra* note 46. This view ignores the words of § 1111(b)(1)(B)(ii), which disqualifies only recourse lenders in case of sale, but Stein's theory does not necessarily depend on his assumption. Note that this view separates § 1111(b) from the *Pine Gate* case, because Stein assumes the election cannot take place in case a sale is planned. In *Pine Gate*, a sale was planned, so that no election could have taken place (in Stein's view) if § 1111(b) existed then.

¹²⁴ The preferred view to be presented later will differ with regard to this condition. See *infra* text accompanying notes 139-151.

¹²⁵ Stein, *supra* note 98, at 212. Stein goes too far in one respect. Stein claims that if the debtor-in-possession does not own the collateral and instead owns stock of a subsidiary that owns the collateral, the cash proceeds of the stock ought to be given to the electing secured party.

This seems wrong. The collateral is fully encumbered and then some. If the subsidiary has a positive value, it must come from assets other than the overencumbered collateral. Therefore, Stein would give wealth unconnected to the collateral to the electing secured party, who at best is entitled only to standard cash proceeds of the collateral itself. See U.C.C. § 9-306(1) (1987).

value of the collateral but additional collateral besides, until the undersecured creditor is fully secured. The Collier treatise states the meaning of Section 1111(b)(2) as follows:

Thus, in the case of the holder of a claim in the allowed amount of \$100 secured by a first lien on property of the estate with a value of \$75 . . . if section 1111(b)(2) applies, the amount of the secured claim would be \$100, the holder would be entitled to retain his lien to the extent of \$100 and receive deferred payments totalling at least \$100 and which have a present value of at least \$75, but the holder would have no unsecured claim.¹²⁶

Professor Theodore Eisenberg echoes this theme in his article on the Section 1111(b) election:

Considering a failed reorganization may illustrate more concretely section 1111(b)'s effects on other creditors. Assume that our undersecured creditor with a debt of \$100 and collateral of \$75 elects to be treated as fully secured because the creditor expects the collateral to appreciate in value. The creditor finds itself with a secured claim of \$100, secured by a lien "to the extent of the allowed amount of such" claim.¹²⁷

That is, even though the collateral is worth only \$75, Eisenberg believes that the plan (soon to collapse) must give the secured party extra collateral, so that the undersecured creditor has fully \$100 in collateral altogether. After collapse, the undersecured creditor is free to foreclose on the \$75 collateral and the additional bonus collateral as well.¹²⁸

The Collier view finds some support in Section 1129(b), which provides, *inter alia*, that, as to dissenting classes of creditors, the plan must be "fair and equitable."¹²⁹ Section 1129(b)(2)(A) defines "fair and equita-

¹²⁶ 3 COLLIER ON BANKRUPTCY ¶ 506.04 at 506-23 (15th ed. 1984).

¹²⁷ Eisenberg, *supra* note 82, at 966 (footnote omitted); see also Pachulski, *The Cram Down and Valuation Under Chapter 11 of the Bankruptcy Code*, 58 N.C.L. REV. 925, 933 (1980) ("For example, a creditor with a recourse claim who is owed a debt of \$100,000, the payment of which is secured by property worth \$60,000 . . . would have a secured claim for \$100,000 and no unsecured claim if the creditor made the § 1111(b) election.").

¹²⁸ Immediately after the above quote, Eisenberg asks us to "[a]ssume . . . that the debtor's reorganization plan is confirmed but that the reorganization effort fails soon after confirmation, before any payments have been made, and after the collateral has appreciated in value to \$100." Eisenberg, *supra* note 82, at 966. Therefore, it could be that Eisenberg would restrict the above rule *only* to cases in which collateral has appreciated beyond the full amount of the secured claim. If so, then Eisenberg's view does not differ from Stein's.

¹²⁹ 11 U.S.C. § 1129(b) (1988).

ble" to mean several alternative things, including the following:

(i)(I) that the holders of [secured] claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, *to the extent of the allowed amount of such claims*; . . .

(ii) for the sale, subject to Section 363(k) of this title, [citation omitted] of any property that is subject to the liens securing such claims, free and clear of such liens, with such liens to attach to the proceeds of such sale, and the treatment of such liens or proceeds under clause (i) or (iii) of this subparagraph; or

(iii) for the realization by such holders of the indubitable equivalent of such claims.¹³⁰

Each of these options is at least consistent with the view that a plan must fully collateralize an electing secured creditor's entire plan. The first strongly indicates as much. Recall that, according to Section 1111(b)(2), electing creditors have "secured claim[s] to the extent that such claim is allowed."¹³¹ Read together with Section 1129(b)(2)(A)(i), these words could imply the following: (1) the undersecured creditor in the Collier example is entitled to only \$75 in present value under the Chapter 11 plan, (2) total cash payments over time must eventually equal \$100, and (3) in the meantime, the secured party must have a lien on \$100 of assets in case the plan fails.¹³²

The other two cram down ideas are not inconsistent with Collier's position either. The second option is that a plan can provide for a sale free and clear of liens, with the secured party getting the cash proceeds.¹³³ As we have seen, a sale in the plan eliminates the election, except for non-recourse lenders. Hence, it is possible that a debtor-in-possession could rely on the second option to satisfy an electing non-recourse creditor's opposition to a plan. The second option does not indicate *how much* collateral must be sold to satisfy the "fair and equitable" standard. Therefore, if the meaning of the election is that the undersecured party must be given

¹³⁰ 11 U.S.C. § 1129(b)(2)(A)(i)(I) (1988) (emphasis added).

¹³¹ 11 U.S.C. § 1111(b)(2) (1982).

¹³² The statement of Congressman Don Edwards accords with this reading: "The advantage to the electing secured creditors is that they have a lien securing the full amount of the allowed claim, so that if the value of the collateral increases after the case is closed, the deferred payments will be secured claims." 124 CONG. REC. H32,408 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); see *supra* text accompanying note 88.

¹³³ 11 U.S.C. § 1129(b)(2)(A)(ii).

additional collateral worth the total amount of her claim, then the extra collateral must be sold as well to meet this idea—not just the the original collateral.

Similarly, the third cram down idea is simply that the secured party be given the “indubitable equivalent” of her state law rights. But if the meaning of the election is now that the secured party should have *more* than her state law rights, “indubitable equivalent” cannot mean that the debtor-in-possession can simply ignore the election and give the secured creditor less than the collateral needed for the full amount of the secured creditor’s claim. Rather, it must mean that more collateral must be supplied pursuant to the Collier interpretation of the election. Thus, to summarize, the first cram down option seems very consistent with the idea that the undersecured party’s full claim must be collateralized in the plan, so that the undersecured party can have a full recovery in case the plan defaults. The second two cram down options are at least not inconsistent with such an interpretation of the election.

Here is another thought in favor of the Collier view. Recall that most authorities assume that a *recourse* lender who elects under Section 1111(b)(2) forfeits her recourse.¹³⁴ This would make complete sense if the Collier treatise were right—that the election means that the plan must completely collateralize an electing creditor’s claim. In such a case, the creditor would be oversecured, and there would indeed be no unsecured deficit to assert against the debtor-in-possession. Thus, the Collier view is consistent with the view that I have presented in this article—that, in case of the election, the electing secured party does not *forfeit* recourse. Instead, the Collier editors simply believe that electing creditors are fully secured creditors who have no cause to make an unsecured claim in bankruptcy. In contrast, I have asserted that an unsecured deficit remains useful even after the election, because it is not necessary for a Chapter 11 plan to fully collateralize an electing creditor’s claim.

Although the Collier view of the Section 1111(b) election can be forced into a reconciliation with the language of the cram down provision, it would pose a significant threat to the entire Chapter 11 idea. To see how, let us use the example in which a lender of \$1,000,000 has collateral worth \$100,000.

If the Collier view is right, the plan from its inception must provide \$1,000,000 in collateral for a claim with a present value of \$100,000. It will not do to let the undersecured party have a lien on the \$100,000

¹³⁴ See *supra* text accompanying text notes 82-88.

collateral at the inception of the plan and to acquire a "springing lien" on undefined extra collateral only on default.¹³⁵ For a plan to be confirmed, a debtor-in-possession would certainly have to show where this extra collateral would come from and at least must promise to keep this collateral unencumbered.

Now many debtors-in-possession will not have the extra collateral to meet this requirement. Even if they do, many debtors-in-possession will not be able to devise a plan in which *other* unsecured creditors get more from the plan than they would from liquidation (where \$900,000 need not be given to the undersecured party).¹³⁶ So read, the Section 1111(b) election becomes an enormous weapon by which radically undersecured parties can force a company with going concern value into liquidation. This means that even in cases where collateral could not possibly appreciate in value (accounts receivable cases, for example), a radically undersecured party has a powerful incentive to gain a crushing power over the Chapter 11 proceeding. And yet the Section 1111(b) election seems clearly aimed at reserving collateral appreciation for undersecured parties. Something must be wrong if the election is still valuable even though collateral is not appreciating in value.

Although not determinative, the legislative history connects the election with appreciating value of the collateral:

The advantage to the electing creditors is that if the plan is crammed down . . . , they have a lien securing the full amount of the allowed claim so that if the value of the collateral increases after the case is closed, the deferred payments will be secured claims.¹³⁷

In this passage, the author of the legislative history assumes that the advantage of Section 1111(b) is connected to an increase in value in the collateral. The Collier view (which requires collateralization of the *entire* claim of the undersecured party) is *not* so connected. Under such a view, the undersecured creditor gets a full recovery (when the plan collapses) whether or not the collateral has increased in value.

To summarize, the orthodox interpretation of Section 1111(b)(2)

¹³⁵ By "springing lien," I mean a lien that does not exist at the outset of the plan but later "springs" into existence for the first time at default. Springing liens are forbidden under 11 U.S.C. § 545(1) (1982 & Supp. III 1985), when a state government tries to create one.

¹³⁶ See 11 U.S.C. § 1129(a)(7) (1988).

¹³⁷ 124 CONG. REC. H11,105 (daily ed. Sept. 28, 1978) (statement of Rep. Edwards); 124 CONG. REC. S17,422 (daily ed. Oct. 6, 1978) (statement of Sen. DeConcini) (emphasis added).

holds that the Chapter 11 plan must give the electing secured party the value of the Section 506(a) ceiling (with the payout period manipulated so that the electing secured party also gets eventual cash payments equivalent to the face amount of the secured party's claim). This interpretation is justified by the claim that (a) there is supposedly some intrinsic value in receiving payments over the long term rather than an equivalent lump sum cash payment today, or that (b) if the plan falls apart, or is modified (so that the collateral is sold), the undersecured creditor gets a bonus beyond the amount of her Chapter 11 entitlement. Within this latter view, there are three subtheories on what advantage a secured party might get by electing. The first "default" view (from *In re Wandler*) states that, *in case the plan defaults*, the secured party simply has rights against the collateral as if no Section 506(a) ceiling exists. The second "due on sale" view (Stein's) is that the secured party has rights against the collateral as if no Section 506(a) ceiling exists, whether or not default occurs, so long as the debtor-in-possession sells the collateral. The third "full collateral" view (from the Collier treatise) is that electing undersecured creditors get at least this, plus enough collateral to guarantee a 100% recovery on the face amount the secured party would like to receive. This third view is the most disastrous, and yet it is not inconsistent with the words of Section 1129(b)(2)(A).

E. A Counter-Reading of Section 1111(b)

There are at least two impracticalities in the orthodox reading of Section 1111(b). First, the orthodox reading of Section 1111(b) forces the debtor-in-possession into adopting extended payouts in order to minimize the wealth transferred from itself to creditors. This inflexibility may not be terribly important; defeasance procedures would allow a debtor-in-possession to wipe such a long term obligation off its books later, if need be.¹³⁸ There is, however, at least one case holding that payout periods cannot be extended past the periods which are customary for the type of loan involved,¹³⁹ and another holds that payout periods may not exceed

¹³⁸ "In substance defeasance" refers to the practice of matching issued debt with federal government securities which have equal maturities and interest rates. Defeased debt permits the debtor's accountants to eliminate debt from the liabilities side of the books in exchange for eliminating the federal securities from the asset side. See generally Fortgang & Mayer, *Valuation in Bankruptcy*, 32 UCLA L. REV. 1061, 1095-96 (1985).

¹³⁹ *In re Foster*, 79 Bankr. 906, 910-11 (Bankr. D. Mont. 1987); see also LoPucki, *supra* note 102, at 491 (1985).

the useful life of the collateral.¹⁴⁰ These cases, if followed, would interfere with the orthodox view of the Section 1111(b) election.

Second, the orthodox reading does not account for investments in the collateral. This is a serious defect. If the value of collateral increases, it will usually do so in response to debtor-in-possession investments in the collateral. Under the orthodox reading, the electing creditor is automatically entitled to the value of the collateral, even if the debtor-in-possession has invested considerably in the collateral and thereby has made it more valuable. This interpretation of Section 1111(b) is a powerful disincentive against debtor-in-possession investment (without some sort of subordination bargain between the electing creditor and the debtor-in-possession).

Suppose, for example, that *A* has lent \$1,000,000 in exchange for a mortgage on vacant land worth \$100,000. The debtor-in-possession decides to invest \$800,000 in putting up the building. The building is eventually sold under the plan for \$1,000,000. We ought to adopt a reading that allows the debtor-in-possession to charge the \$800,000 investment against the entitlement of the undersecured creditor. Otherwise, the debtor-in-possession loses the investment and merely enriches the undersecured creditor, or, more to the point, the debtor-in-possession refuses to make the investment. At a minimum, it ought to be the case that the amount invested can be charged to the collateral under Section 506(c).¹⁴¹

The proposed alternative reading is simple: the election means only that electing creditors are never subject to final Section 506(a) valuations. In the case of electing (recourse or non-recourse) creditors in Chapter 11 plans contemplating no sale of the collateral, the electing undersecured creditors are entitled to a second look later on to make sure that no collat-

¹⁴⁰ *In re White*, 36 Bankr. 199 (Bankr. D. Kan. 1983).

¹⁴¹ Section 506(c) provides:

The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim.

Actually, even if the debtor-in-possession can recover the \$800,000 investment under Section 506(c), the debtor-in-possession will not make the investment, based on the numbers we are working with. What is the sense in investing unless the debtor-in-possession can gain a *return* on investment that is better than any alternative investment? Only if the collateral can be improved so that it is worth more than \$1 million will it provide a return to the debtor-in-possession.

Privately negotiated solutions are easily attained, however. The debtor-in-possession could offer to invest the \$800,000 if the electing creditor would split the surplus with the debtor-in-possession. Such a possibility, viewed *ex ante*, means that when the parties can bargain about the matter, no interpretation of Section 1111(b) matters much. But in cases in which the debtor-in-possession has already made the investment, it might be useful to have a ruling that allows for a charge against the undersecured creditor of the Section 506(c) investment expense.

eral appreciation has occurred.¹⁴² If so, then the electing creditors should receive additional entitlements. This second look is not free from procedural difficulties,¹⁴³ but fortunately, collateral that is used instead of sold rarely increases in value. Therefore, these problems will rarely be faced because few undersecured creditors will elect a second look when it is likely to go against them.

In the more common case, where sales are contemplated, only non-recourse lenders can elect.¹⁴⁴ For these lenders, Section 1111(b)(2) should also be read to eliminate the Section 506(a) ceiling. Thus, when the collateral is finally sold, they receive proceeds up to the amount of their claim (and no more).¹⁴⁵ In the meantime, these creditors are entitled to keep their liens on their collateral (or collateral of equivalent value). They are *not* entitled to additional collateral.

Under the proposed interpretation of the Section 1111(b) election, the debtor-in-possession is not required to pay the full face amount of the electing secured party's claim over time. Such an exercise is sterile. Instead, the plan need only give the electing secured party the Section 506(a) ceiling. Any payout period that does the job will do.

One of the benefits claimed for a required long payout period is that the secured party cannot be cashed out immediately. This supposedly prevents the debtor-in-possession from ridding itself of the undersecured creditor and thereafter expropriating the increased value of the collateral. The proposed interpretation of Section 1111(b)(2) would allow for immediate cashouts, but the debtor-in-possession would not be able to deprive the undersecured creditor of increased collateral value. Even if the electing creditor receives cash, it will still be possible for that creditor to obtain a reassessment of the Section 506(a) ceiling at a later time. Receipt of im-

¹⁴² In contrast, Jeffrey Stein would suspend the § 506(a) ceiling only if a sale actually occurs. See *supra* text accompanying notes 124-126.

¹⁴³ Once the Chapter 11 plan has gone into effect, the bankruptcy proceeding is ordinarily considered terminated; the automatic stay in bankruptcy lapses, and the relations between the undersecured creditors and the debtor are now governed by the Chapter 11 plan. If the debtor-in-possession thereafter obtains increased value in the collateral, and if the undersecured party had a right to this increased value, there would have to be some procedure whereby the undersecured creditor's debt instruments are recalled and reissued, so that the new debt instruments equal the newly increased value of the collateral. This would require a bankruptcy court to retain jurisdiction over a Chapter 11 plan, even after it is confirmed. See 11 U.S.C. § 1141 (1982 & Supp. III 1985) (implying the court may make exceptions to the usual post-confirmation rules).

¹⁴⁴ 11 U.S.C. § 1111(b)(1)(B)(ii) (1982) (by negative implication).

¹⁴⁵ Their claim, however, will be augmented by post-bankruptcy interest, because that is what oversecured creditors are entitled to under § 506(b). *Accord* Provident Bank v. BBT (*In re* BBT), 11 Bankr. 224, 231-32 n.12 (Bankr. D. Nev. 1981).

mediate cash would not negate this right.

The proposed reading of Section 1111(b)(2) is consistent with the statutory language. To repeat once again, Section 1111(b)(2) provides:

If such an election is made, then notwithstanding Section 506(a) of this title, such claim is a secured claim to the extent that such claim is allowed.¹⁴⁶

Based on my reading, if "such claim" happens to be a non-recourse claim, it is only allowed up to the undersecured creditor's claim or the amount of the collateral, whichever is less. If "such claim" is a recourse claim (*i.e.*, no sale is contemplated), the recourse would *not* be forfeited by an electing creditor. The underwater claim is still partly a secured claim and partly an unsecured one with the understanding that second looks will be permitted to redivide the total claim between its secured and unsecured parts. An increase in the secured claim would portend a decrease in the unsecured claim.

Meanwhile, if the debtor-in-possession invests \$800,000 and thereby receives the value of the collateral up to \$1,000,000, the debtor-in-possession may charge this investment against the collateral under Section 506(c). In case of a sale under the plan, the electing (non-recourse) undersecured creditor will be entitled to the \$200,000 of sales proceeds because the \$800,000 investment will be deducted from the proceeds.

It is a fair question to ask what happens to the electing undersecured party when the value of the collateral goes down, contrary to expectations. If this occurs, the undersecured party takes the loss. That is, those who make the election assume the risk of upward *or* downward movements in value. Now it is true that secured parties are entitled to adequate protection against deteriorating collateral values,¹⁴⁷ but this is a right which terminates when the Chapter 11 plan is confirmed.¹⁴⁸ Therefore, adequate protection is no impediment to this view, and the fear of depreciation from any source would count as a powerful disincentive to make the election.

¹⁴⁶ 11 U.S.C. §1111(b)(2) (1982).

¹⁴⁷ 11 U.S.C. § 363(e) (1982 & Supp. IV 1986).

¹⁴⁸ See Carlson, *Postpetition Interest Entitlements Under The Bankruptcy Code*, 43 U. MIAMI L. REV. 577 (1989). Ironically, the term "adequate protection" comes from a post-confirmation statute under the old Bankruptcy Act, but today the term applies only to pre-confirmation proceedings. *Id.*

III. CONCLUSION

Valuations in bankruptcy are difficult enough at the level of price theory. This article has also pointed out the complex *legal status* of a bankruptcy valuation. Section 506(a) may stand for the proposition that strict ceilings can be placed on an undersecured creditor's allowed secured claim. Such a view is implied by the bid-in protection in Section 363(k) and by the lien avoidance provision in Section 506(d). Nevertheless, I have argued that both common sense and legislative history support the view that Section 506(a) valuations can be changed any time before a sale or a Chapter 11 plan is confirmed. Only valuations in Chapter 11 plans are strict limits. And for such ceilings, the Section 1111(b) election stands as relief.

The election in Section 1111(b) is an extraordinarily difficult provision in the Code. It cannot be read too literally. At best, the Code can be read in a way that limits undersecured creditors to the value of the collateral, after expenses for the preservation and improvement of the collateral are charged to the undersecured creditor's account. As such, the election becomes little more than a guard against bad valuations of collateral under Section 506(a). The reading I have proposed is not flatly contradicted by any words in the Code and avoids some unacceptable results of the current orthodox view of what the election means.

Having dealt with the words of the Code, a little more might be said about what should happen to undersecured creditors in bankruptcy, if we could work from a clean statutory slate.

There is a hidden property issue at stake in the debate over undersecured creditors in bankruptcy: To what extent does the undersecured creditor own potential increased value of collateral, and to what extent should completely unsecured creditors own it, once a bankruptcy petition has been filed? A construction lender whose loan buys the materials and labor needed to increase the value of the collateral will certainly argue that, but for her loan, the increased value would not exist. On an analogy to purchase money superpriority,¹⁴⁹ the lender would claim ownership of the increased value. On the other side, the general creditor will argue that *her* exposure to the risk of nonpayment also contributes to the debtor's financial existence, and that *her* unsecured risk is qualitatively the same as the undersecured creditor's risk. Equality of treatment argues that the increased value be shared pro rata. In addition, for the *secured* part of the

¹⁴⁹ UCLA Note, *supra* note 2, at 1963.

claim, an undersecured creditor is protected from any *decrease* in value. Why should such a creditor receive any improvement in value when she faces no risk of any decrease in value?¹⁵⁰

This latter argument upholds against congressional judgment the wisdom of the *Pine Gate* decision, which implied that the increase in value must be shared by all who take an unsecured risk. Indeed, it is hard to distinguish the risks faced by an unsecured and an undersecured creditor. One finds a strong policy favoring equal treatment of these risks in the Bankruptcy Code's treatment of after-acquired property liens. When a security agreement provides for the secured party to receive after-acquired property as collateral, Article 9 authorizes the enforcement of that clause.¹⁵¹ The Bankruptcy Code, in contrast, disencumbers all property acquired after the bankruptcy petition is filed.¹⁵² The distinction between after-acquired property and existing property that appreciates in value is not great for these purposes.¹⁵³ Therefore, equality among creditors without security demands that there be no election at all.

If improvement in value belongs to the bankrupt estate in general, it probably follows that there be a strict ceiling established by Section 506(a). If Section 506(a) is not a ceiling—if bankruptcy courts can amend

¹⁵⁰ Shanker, *An Integrated Financing System for Purchase Money Collateral: A Proposed Solution to the Fixture Problem Under § 9-313 of the Uniform Commercial Code*, 73 YALE L.J. 788, 791 (1964) (making this argument in the context of fixture priorities).

¹⁵¹ U.C.C. § 9-204(1) (1987).

¹⁵² 11 U.S.C. § 552(a) (1982 & Supp. III 1985). Section 552(b) goes on to save security interests in proceeds, offspring, and the like.

One can find an "equality" policy in the voidable preference Section as well. 11 U.S.C. § 547(e)(3) (1982 & Supp. IV 1986) makes it clear that after-acquired property is deemed transferred to the secured party when the debtor actually acquires the property (and not before, as had been the case under earlier bankruptcy law). As a result, after-acquired property transferred from the debtor to the secured party within 90 days of bankruptcy is potentially a voidable preference. This denial of after-acquired property to undersecured creditors is substantially tempered by § 547(c)(5), which saves from avoidance all security interests in inventory and receivables (to the extent that the secured party does not improve her position over the preference period). The technicalities of after-acquired property and voidable preference law could not be more complicated. For those who find this footnote opaque, an exhaustive account is provided in Breitowitz, *Article 9 Security Interests as Voidable Preferences (Pt. II: The Floating Lien)*, 4 CARDOZO L. REV. 1 (1982); see also Countryman, *The Concept of a Voidable Preference in Bankruptcy*, 38 VAND. L. REV. 713, 790 (1985); Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 768-77 (1984).

¹⁵³ See *In re Tanner*, 14 Bankr. 933, 936-37 (Bankr. W.D. Pa. 1981) (equating post-bankruptcy increases of value with property acquired after the petition). This claim that the unsecured risk is the same for both classes of creditors not only applies to increased value arising from investment but also to straight fluctuations in commodity prices. If the collateral is gold bars and if gold appreciates in value after a bankruptcy, an undersecured creditor has still taken an unsecured risk that seems indistinguishable from the risk other general creditors take on the same commodity.

the division between secured and unsecured portions of the underwater claim—then the increased value in the future (from investments) effectively belongs to the secured party, because the secured party can always recapture increased value in the follow-up Section 506(a) valuations. We can see, therefore, that the ownership question determines the answer to whether we should have a “strict-ceiling” interpretation of Section 506(a).

Even if the expectations of undersecured creditors are entitled to priority over general creditors’ expectations, we still do not need the election, so long as we have a flexible interpretation of Section 506(a). The constant availability of a “second look” prohibits the bankruptcy trustee from expropriating, for general creditors, the earnings opportunity that accelerating value represents.

Which view is better? I have no idea. There seems to be no great moral difference I can discern for favoring general creditors over undersecured creditors.¹⁸⁴ But here is a thought unconnected with theories of desert. One possible moral factor is that Section 506(a) valuations are frequently “wrong.”¹⁸⁵ A “second look” doctrine would protect against poor valuations, but it is hard to say who benefits and who loses from wrong valuations. It is often *claimed* that bankruptcy courts have a bias against undersecured creditors and for general creditors. *If* this were right, an entitlement in favor of undersecured creditors would eliminate more wrong valuations than would an entitlement for general creditors. Alternatively, if I were a believer in law-and-economics, I would try to find the welfare-maximizing solution (even though any solution I asserted would undoubtedly be empirically invalid).¹⁸⁶ Nevertheless, I might timidly suggest that limited liability of corporations exports major costs to potential and actual tort victims, that secured lending allows voluntary creditors to avoid the risk of limited liability, and that by awarding post-bankruptcy

¹⁸⁴ I might favor *tort* creditors over voluntary creditors, but I see no difference between the risk that *voluntary* general creditors and undersecured creditors take in lending to a debtor.

¹⁸⁵ That is, the valuations in court do not match up with the value realized later in a sale. It is usually assumed that the judge, not the market, is wrong.

¹⁸⁶ Cost-benefit analysis depends absolutely on discovering *all* the costs and benefits actually incurred. Law-and-economics practitioners can only do this by consulting all the people affected. If you posit a world, however, in which people are not self-interested, this consultation can never end until you have consulted the whole world. Carlson, *Rationality, Accident, and Priority Under Article 9 of the Uniform Commercial Code*, 71 MINN. L. REV. 207, 226-29 (1986). The dangers faced by law-and-economics practitioners were concisely described by the great Arthur Alan Leff:

If a state of affairs is the product of n variables, and you have knowledge of or control over less than n variables, if you think you know what's going to happen when you vary “your” variables, you’re a booby.

Leff, *Economic Analysis of Law: Some Realism About Nominalism*, 60 VA. L. REV. 451, 476 (1974).

value to the bankrupt estate, undersecured creditors would be forced to charge higher interest rates because of increased risk. This higher charge will chase more and more marginal producers out of the market, thereby reducing the amount of externalities imposed on the public. This assignment of entitlements *might* serve to reduce the amount of uninsured hazards produced by American businesses. But such a claim can only be suggested most tentatively, because I have no data to support this claim.¹⁸⁷

Although I have no moral intuition to offer about who should own post-bankruptcy increases in valuation, I hope that, at least, I have spelled out what the competing views of Section 506(a) entail. For those who think the general creditors should win, a strict Section 506(a) ceiling is essential. For those who think undersecured creditors should win, a constantly shifting division between secured and unsecured claims under Section 506(a) would be simpler and cleaner than the current Section 1111(b) election.

¹⁸⁷ Most *real* data show that lenders do not care at all about marginal changes in debtor-creditor law. *E.g.*, Shuchman, *Data on the Durrett Controversy*, 9 CARDOZO L. REV. 605 (1987) (controversial anti-creditor fraudulent conveyance rule on foreclosure sales has no visible effect on the price of credit); Shuchman, *Theory and Reality in Bankruptcy: The Spherical Chicken*, 41 LAW & CONTEMP. PROBS. 66, 76-83 (Autumn 1977). If so, law-and-economics engages in self-aggrandizing functionalist fallacies: that what lawyers do actually *matters* to human behavior. Clearly sometimes it does. But law-and-economics forgets that sometimes it does not.